2003

Banks, credit unions, and other lenders and depository institutions industry developments - 2003-04; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Bank, Credit Union, and Other Depository and Lending Institution Industry Developments — 2003/04

Strengthening Audit Integrity
Safeguarding Financial Reporting

American Institute of Certified Public Accountants

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Notice to Readers

This Audit Risk Alert, prepared by the AICPA staff, is intended to provide auditors of financial statements of banks, credit unions, savings institutions, finance companies, and other depository institutions and lenders with an overview of recent economic, industry, regulatory, and professional developments that may affect the engagements and audits they perform.

This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Accounting and Auditing Publications

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Bank, Credit Union, and Other Depository and Lending Institution Industry Developments—2003/04

How This Alert Helps You

This Audit Risk Alert helps you plan and perform your audits of financial institutions and other lenders. The Alert can also be used by a company's internal management to address areas of audit concern. The Alert delivers knowledge to assist you in achieving a more robust understanding of the business environment in which your clients operate. The Alert is an important tool in helping you identify the significant business risks that may result in the material misstatement of financial statements. Moreover, this Alert delivers information about emerging practice issues and about current accounting, auditing, and regulatory developments.

If you understand what is occurring in the financial institution industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining and understanding that industry knowledge.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2003/04*.

Industry and Economic Developments

Note: See the AICPA general *Audit Risk Alert—2003/04* for information about the U.S. and international economies.

Financial Institutions and the Economy

Financial institutions have fared relatively well over the past year as mortgage and other consumer lending carried the burden for many institutions. Consumer lending offset weakness in market-sensitive areas such as investment banking, trading and asset management. The low interest rates of the past two years have brought down mortgage rates, spurring home sales and enabling many households to refinance and improve their cash flow, while making it possible for automakers and dealers to offer no-interest loans. However, during the second half of 2003, specialty mortgage lenders, small banks and thrifts may have a hard time maintaining or increasing earnings if an interest rate rise reduces mortgage volume. Additionally, consumers, wary of the stock market, have been depositing funds in savings accounts, thereby increasing an institution's liquidity and reducing capital investment.

In the commercial sector, fee income volume compensated for increased loan losses. The Federal Deposit Insurance Corporation (FDIC) noted that second quarter noncurrent commercial real estate loans had the largest quarterly increase in a year and a half. Inventory investment is still weak and the economy will not improve significantly until capital spending picks up again. However, once again, commercial banking has outperformed investment banking due to the tepid merger and acquisition market. It is feasible, however, that mergers and acquisitions could pick up in late 2003 if weak earnings trigger a new round of consolidations.

Credit quality results have been mixed, with certain institutions showing improvement or stability in consumer or commercial areas and some institutions showing weakness in portfolios with specific emphasis on subprime lending. For additional information, see "Credit Quality Update" in the "Credit Risk Watch" section of this Alert. However, it is important to note that management concern has expanded beyond credit quality to market interest rate risk. Many institutions are concerned that the margin spread has become too small for profit in many traditional outlets. For an expanded discussion, see the following section "The Margin Squeeze," of this Alert.

Auditing Consideration: Product Mix and Audit Risk

The business considerations, risks, and issues facing financial institutions are immense: an explosion of accounting and auditing rules, increased federal regulatory compliance, the lowest interest rates in 58 years, a myriad of tax incentives, economic indicators that can't predict which way is up, corporate governance pressures, and mixed credit quality. Financial institutions are jumping to respond to these and other variables in order to maintain revenue streams and customers. The product mix on the balance sheet could shift drastically in response to these changes and transform almost every area of client business. Management will be scrambling in response and audit risk is likely to intensify at your clients.

The Margin Squeeze

Market risk is playing a larger role this year in the management and success of financial institutions. Net interest margin is the revenue driver for almost every aspect of an institution's operations: loans, investments, deposits, debt, and derivatives.

Margins have decreased with the decline in interest rates; institutions have less of a spread between what they charge to lend and what it costs to obtain funding. Small and regional institutions will be more affected than larger firms, as their operations are not as diversified in other areas such as securities underwriting, cash management or merger advising.

Financial institutions reluctantly dropped their prime rates in response to the Federal Reserve Board's (FRB) cut to 1 percent in June 2003. Many institutions are concerned that the margin spread has become too small for profit. Financial institutions have fared well throughout the past year because exceptionally low interest rates have led to a robust mortgage and refinancing market, which has substantially increased the volume of customers paying loan origination and servicing fee revenues. However, institutions now have little room to manipulate margins; aggregated loan volume may no longer compensate. Additionally, if institutions lower deposit rates any further, they could lose customers to more attractive investments.

Income from individual loans has decreased as individual mortgage and mortgage-servicing rights revenues for each loan dropped along with interest rates. Mortgage-backed securities now may consist of refinanced loans earning a lower rate of interest. Institutions are trying to unload these low earning instruments in anticipation of an interest rate rise and potential related impairment. Additionally, since the right to service a mortgage disappears once it is refinanced, retained mortgage-servicing rights as well as loan-origination costs could also become impaired. Furthermore, the competition to increase loan origination volume may have contributed to the softening of credit criteria, further increasing credit risk. Finally, credit card earnings suffer as customers demand higher credit lines and lower rates, or defect to competitors.

If short-term interest rates rise, it could just be a temporary fix if the yield curve flattens in response. On the bright side, there has been room for the squeeze, since margins were at unusually wide levels during much of 2002. If recent positive signs are truly the start of a recovery, institutions should be able to cope. If rates drop any lower, the margin squeeze may become tough to handle.

Some Audit and Accounting Considerations

Institutions are subject to prepayment risk in falling interest rate environments. Mortgage loans and other receivables may be prepaid by a debtor to refinance obligations at new, lower rates. Therefore, prepayments of assets carrying the old, higher rates reduce the institution's net income and overall asset yields. The low interest rates have had an impact on previously recorded assets for retained mortgage-servicing rights and capitalized loan origination costs. The auditor may have to assess the risk of impairment caused by refinancings on these previously recorded assets as well as the reasonableness of their established amortization periods. These assessments may result in significant adjustments and/or charges to income being made in the audit process if they have not been considered by the client during the year. See the article "Capitalization and Valuation of Mortgage-Servicing Rights" in the "In the Spotlight" section of the Alert for further discussion.

Additionally, since many mortgages have been refinanced, second-mortgage lenders rank below first-lien holders in collection efforts, and the holder of the second lien is not able to collect until the first lender has been satisfied. Therefore, the auditor should note the creditor status of the client's portfolio base.

The margin spread affects earnings, liquidity, loan demand, and asset values. The inherent risk on the client's asset values and capital described in the aforementioned paragraphs should be considered. You can refer to SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), and its companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk). Additionally, SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 328), provides guidance to the auditor for many balance sheet components. Other applicable literature includes Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 140, *Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The Audit and Accounting Guides *Banks and Savings Institutions*, *Audits of Credit Unions*, and *Audits of Finance Companies*, are being combined into a new Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions*, *Credit Unions, Finance Companies and Mortgage Companies*, and is due to be published by the AICPA in 2004. This new Guide will incorporate changes from SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others.* Additional loan loss guidance is located in the "Credit Risk Watch" section of this Alert.

Auditing restructuring charges may be in store if institutions reduce loan servicing departments if the mortgage boom fades. You can refer to FASB Statements No. 146, *Accounting for Costs Associated With Exit or Disposal Activities*, and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* Additional guidance for public clients is included in Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 100, *Restructuring and Impairment Charges*, which provides guidance on the accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations, and the recognition and disclosure of asset impairment charges.

Finally, you may need to consider whether the institution has adequate asset/liability management procedures in place to understand and manage its market risk and liquidity in the current interest rate environment. Does the financial institution have an in-house asset/liability management program or has it outsourced asset/liability management to an outside vendor? If the institution has an in-house program, management needs assurance that the program is operating properly. If an outside vendor is used, management needs to fully understand the vendor's modeling results and the assumptions used. The degree of sophistication needed will vary with the complexity of the balance sheet. SAS No. 70, *Service Organizations*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*, SAS No. 88, *Service Organizations and Reporting on Consistency*, and SAS No. 98, *Omnibus Statement on Auditing Standards—2002* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance on the factors and clarifies applicability that an independent auditor should consider when auditing the financial statements of an entity that obtains services from another organization that are part of its information system.

Competition—Banks Versus Credit Unions

Banks and credit unions have taken out their boxing gloves this past year. Credit unions continue to win key regulatory and legislative battles on state and federal levels, and have subsequently increased marketing campaigns. In response to increased competitor pressure, banks have launched their own marketing campaigns and lawsuits.

A number of recent changes have benefited credit unions. In 1998, The Credit Union Membership Act permitted credit unions to broaden their fields of membership. In 2003, the Small Business Administration expanded its 7(a) lending program to include tax-exempt credit unions. The 7(a) program is exempt from the credit union business lending cap of 12.5 percent of assets.

Rules have been passed making it easier for federal credit unions to adopt all-inclusive community charters. Moreover, a credit union trade organization recently made a deal with the Federal Home Loan Mortgage Corporation (FHLMC, also known as Freddie Mac) in order to bypass barriers of entry into the secondary loan market.

In response, banks are behind a number of proposals to keep credit unions from expanding. In several states, banks are trying to remove credit union tax-exempt status and other powers. One instance occurred in July 2003 when the American Bankers Association and the Utah Bankers Association announced a joint suit against the National Credit Union Administration (NCUA) challenging the agency's recent approval of a six-county community common bond. The suit also challenges the conversion of two large state credit unions to federal charters using the same geographic common bond.

Community banks feel the pressure; credit unions can price products lower due to their tax-exempt status and offer especially competitive rates on products such as certificates of deposit.

Small Bank Report

How are current economic conditions affecting small banks? Here are some highlights from the year to keep in mind during your audit planning and risk assessment.

- The majority of this year's mergers and acquisitions involved small banks. There was growing popularity of cash deals due to (1) the elimination of the pooling-of-interests method, and (2) the current volatility of stock prices in the market. Additionally, most 2003 initial public offerings involved small banks.
- As stated above, small banks have been losing market share to credit union competition.

- The Wal-Mart settlement will hurt small banks more so than large banks. Interchange revenue from debit fees is predicted to decline by about a third, and retailers may choose to not accept debit cards (but to still accept credit cards). As most credit cards are issued by large banks, a consumer's shift to credit card spending will hurt the small bank.
- There are fewer start-up banks this year, and the low interest rate environment has hurt existing de-novos as they generally pay higher rates to attract deposits from other institutions. New banks must also charge interest rates high enough to cover start up expenses. These factors squeeze profitability.
- In today's complex asset/liability management environment, small banks have increased reliance on investment management risk consultants to optimize yield; external advisory controls may be lacking or management may not understand increased investment complexities.
- Some small banks and thrifts reported record profits in 2003 as consumers put more money in deposits, took out mortgages, and borrowed against equity. Profits soared because the primary business for small banks and thrifts is mortgage and consumer lending. (However, without portfolio diversification, they are more vulnerable to the margin squeeze.)
- Small banks may be shouldering increased fraud burden; thieves know that large banks have invested more in detection systems. Small banks need to pay attention to authenticating the identity of new customers. Some small banks have only recently added Internet banking and check imaging and may not have proper controls over these functions.
- Small Ticket Leasing is a potential area of expansion for small banks; they can enter into collaborative efforts with brokers and other lessors. However, some small banks may be over relying on the expertise of these external parties.

- In some geographic areas, small banks sold home loans to the secondary market this year due to low interest rates and outreach efforts by secondary market institutions. If servicing has been retained, small banks should review servicing assets for impairment. Additionally, these banks may have situations where loans have been sold with recourse which need to be evaluated under FASB Interpretation (FIN) No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees*.

Freddie and Fannie News

Increased regulation could occur at the nation's government-sponsored enterprises (GSEs), prompted by Freddie Mac's recent earnings restatement. Stakeholders continue to question if proper internal accounting controls currently exist at the GSEs.

The two mortgage-banking GSEs are suffering from the same margin squeeze that ails other financial institutions. A potentially large ripple effect could affect the entire industry as Freddie and the Federal National Mortgage Association (FNMA, also known as Fannie Mae) own or guarantee approximately 40 percent of the mortgage loan market.

Two variables could increase the cost of secondary mortgages. First, if consumers become wary of Freddie's and Fannie's stability and security, liquidity at those GSEs will decrease, causing an increase in their borrowing cost. This cost will pass onto financial institutions and consumers.

Second, if GSE powers are reduced through legislation, GSE operating costs could increase. Currently, Freddie and Fannie do not have to register their securities with the SEC. GSEs are exempt from state and local income tax and have lower capital requirements than comparable institutions. They also have a large line of credit with the U.S. Treasury. This very special relationship leads investors to believe that their debt is backed by the full faith and credit of the federal government, which also reduces borrowing costs. Finally, GSEs are assigned low-risk weights for bank and thrift risk-based capital and investment diversification standards.

Credit Quality Update

Commercial Lending

There are five commercial real estate sectors: office, hotel, industrial, multifamily, and retail. Commercial real estate lending is highly cyclical, and all segments have been affected to some extent by the current economy. There is a significant amount of available subleased office space which is negatively affecting this sector. Manufacturing has decreased, leading to space reductions at blue chip companies. Additionally, major bankruptcies have hurt the commercial lending sector.

Delinquent loans, as a percentage of total commercial loans, hit their highest level in a decade in the fourth quarter of 2002. Credit default appears to have stabilized in mid to late 2003; however, increased regulatory pressure will continue to force institutions to focus on maintaining strong underwriting standards. Commercial and industrial loan volume has decreased this past year. Additionally, asset-based lending has emerged as the financing of choice for cash strapped companies. No longer the loan of last resort, asset-based credit has become a mainstream form of lending, especially for manufacturing and retail. Asset-based lenders rely on the value of underlying collateral such as plant, property, equipment, inventory, and accounts receivable in order to secure a loan. Financial institutions have successfully cross-sold asset-based credit to customers, which changes the substance of credit terms.

Some Auditing Considerations. Audit procedures may have to be expanded to encompass the variables of asset-based lending. During the audit, you may need to assess the existence, valuation, and ownership of the asset collateral supporting your client's receivables. If the client is new to the area of asset-backed lending, you may need to determine if the internal control systems have been properly designed. An efficient asset-backed lender needs a robust system for maintaining control of the underlying assets. For retail credit-related asset-backed securitizations, you should understand the nature of any subprime lending activities and the increased regulatory risk associated with such lending. Finally, the auditor should note that more Standard & Poor's rated asset-backed securities were downgraded in 2003 than ever before; this trend is indicative of a decline in credit quality (and increased impairment) underlying the asset-based securities market.

Additionally, the decreased volume of commercial loan portfolios has not necessarily led to a decline in defaults. Some difficult economic conditions have led to an increase in subprime loans and the auditor must be aware that a greater percentage of portfolios may fall into this category. Finally, the auditor needs to be cognizant that commercial real estate lending regulatory requirements have increased over the past year and loan contracts need to be in compliance with new rules.

Housing Activity

Housing activity has been a boom to financial institutions, supplying much of the needed revenue base this past year. However, some thrift and mortgage lenders may not be healthy; they have had their ratings downgraded. Home equity lending has tapered off and delinquencies are increasing. The federal banking agencies have noted that possibly half of U.S. family mortgages may be subprime, and delinquencies on subprime loans continue to rise. Low rates and accelerated prepayments have also been hurting results. Additionally, mortgage originations have started to fall recently. Solid interest income and non-interest income from mortgage fees may decrease.

Some Auditing Considerations. Auditors should be attentive to these potential hidden pitfalls that surround strong revenue results that come from new loan volume. New loan officers hired during the housing boom who have not experienced a downturn may have loosened credit standards beyond management's awareness. Securitized assets based on a subprime loan base may be impaired. Moreover, the value of any securitized loans brokered and held for sale needs to be evaluated. Additional considerations are discussed in "Housing's Hidden Liabilities" in this section of the Alert.

Credit Cards

Certain financial institutions have been encountering cash flow problems due to an increase in consumer default on credit card debt. Smaller lenders with a higher percentage of credit card portfolios may be more adversely affected. Institutions may need to adjust their credit risk models to better reflect economic conditions. Recently, however, credit card loss rates have declined for some.

Note that the Fair Lending Credit Reporting Act may not be extended this year; state controlled rules for credit reporting could produce a lack of geographic uniformity for credit reports. Additionally, the Wal-Mart suit will cause debit interchange fees for banks to fall by about one-third; institutions may make up the loss in volume by lowering credit card standards.

For additional discussion on credit card auditing, see the following article "Credit Card Focus: Lending and Regulatory Concerns With Account Management and Loss Allowances" in this section of the Alert.

Additional Auditing Considerations

When evaluating credit risk, the quality of loans, and the adequacy of loan loss allowances, auditors should consider the matters discussed and determine whether there is a heightened level of audit risk. If so, it may be necessary to alter the nature, timing, and extent of audit procedures and to increase the level of testing. The evaluation of loan quality and loss allowances can be a complicated process, and the following specific literature will aid you in the accounting and auditing process. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and the AICPA Practice Aid entitled *Auditing Estimates and Other Soft Accounting Information* provide guidance on auditing estimates. Additionally, for relevant accounting guidance, see "Current Loan Guidance—Late 2003" in this section of the Alert.

Credit Card Focus: Lending and Regulatory Concerns With Account Management and Loss Allowances

In response to the rise in consumer debt and defaults, credit card lending has become a high risk area for both regulatory banking examinations and independent audits for institutions with material credit card portfolios. Often, credit quality improves during a refinancing surge as homeowners apply extra liquidity to debt payments. However, this has not necessarily occurred during the current refinancing boom, which may be an indicator of increased credit delinquency over the next year.

The Office of the Comptroller of the Currency (OCC), the FRB, the FDIC and the Office of Thrift Supervision (OTS) ("the Agencies"), issued Account Management and Loss Allowance Guidance for Credit Card Lending on January 8, 2003 ("the guidance"). The guidance communicates expectations for prudent practices in a variety of account management, risk management, and loss allowance practices of institutions engaged in credit card lending. While institutions may require time to implement changes in policies, practices, and systems in order to achieve full consistency with the guidance, the guidance states that institutions should work with their primary federal regulator to ensure implementation as promptly as possible.

The account management portion of the guidance covers credit lines, overlimit practices, negative amortization, workout programs, and settlements. The loss allowance portion of the guidance covers a number of factors that should be considered by institutions when they estimate and account for their allowance for loan losses. A common element in both areas is the need for institutions to document any analyses and decision processes used in managing the policies and procedures related to credit card lending. This documentation requires a management information system that is appropriate for the size and complexity of the credit card portfolio.

For the external auditor, audit risks exist in such areas as portfolio valuation, revenue generation, and internal control risk management. The auditor can use the information in the regulators' guidance below to analyze management compliance and incorporate applicable items into testwork. (The Agencies indicated that in well managed programs, there may be limited exceptions to the guidance. In those cases, the institution must document those policy exceptions and describe why they are warranted.)

It should be noted that many smaller institutions are pass-through entities for credit card operations, with larger financial institutions holding the majority of the assets and related risks. For the particular institution being audited, the CPA must note the contractual liability parameters, the location and scope of management decision-making, and the location of internal controls in order to plan accordingly.

Account Management

Credit Line Management. Institutions must carefully consider the repayment capacity of borrowers when initially granting credit, when granting overlimits, and when increasing credit either through credit line increases or issuance of additional cards. Items to be considered are risk scores, behavior scores, repayment history, and other relevant data. These considerations should be part of written policies that are tested and analyzed using rigorous management information systems supported by strong internal controls. When inadequately managed and analyzed, practices such as multiple card strategies and liberal line-increase programs can lead to significant portfolio deterioration.

Overlimit Practices. Overlimit fees are imposed when a customer has gone past his or her credit limit. Prudent overlimit practices include appropriate management information systems and the establishment of controls, limits, and repayment policies related to the credit risk of the account holder and the credit risk inherent in the portfolio. While not prohibited by the Agencies, and while recognized by the Agencies as a standard practice, institutions must have appropriate documentation and analysis to evaluate the additional credit risk, if any, for such practices, especially for subprime customers. Note that institutions can earn a significant portion of revenues from overlimit fees.

Minimum Payment and Negative Amortization. The Agencies expect lenders to require minimum payments that will amortize the current balance over a reasonable period of time consistent with a borrower's documented creditworthiness. This is a very subjective area for credit card lenders. Increasing minimum payments beyond industry averages may drive away prime borrowers and increase delinquencies. Decreasing minimum payments may reduce cash flows. While there are no bright lines in setting minimum payments, the guidance states that credit risk is "exacerbated when minimum payments consistently fall short of covering all finance charges and fees assessed during the billing cycle and the outstanding balance continues to build" (for example, negative amortization). Negative amortization is specifically criticized by the Agencies with respect to accounts in workout programs or accounts experiencing delinquencies. Such practices have the effect of artificially improving the earnings of an institution through the imposition of fees and interest charges that have a reduced likelihood of collection.

Workout and Forbearance Practices. Workout programs involve changing the status and terms of accounts to help borrowers repay obligations that may otherwise have resulted in charge-offs. The changed status may involve reduced interest rates and fees, scheduled repayment terms, no additional charges allowed on the account, and forgiveness of certain amounts of debt in exchange for specified performance on the part of the borrower. Often when delinquent accounts are placed in a workout program, the account is re-aged and shown as current. The account will remain current as long as the account holder complies with the workout terms and conditions.

Workout programs may be used to mask poor portfolio performance by shifting otherwise delinquent accounts between multiple workout programs, by having poor systems to monitor performance of the workout programs, and by allowing negative amortization of accounts in the workout programs. Workout programs should be designed to maximize principal reduction and should generally strive to have borrowers repay the card balance within 60 months. This may involve substantial reduction or elimination of interest charges and fees during the workout period. Accounts should not have been re-aged more than once within any 12-month period and no more than twice within any five-year period. Additionally, the institution should have documentation of communication with the borrower and his or her renewed willingness and ability to pay the outstanding debt.

Settlements. In certain circumstances an institution may agree to "forgive" a portion of a credit card balance in exchange for the borrower making a lump sum payment or a series of payments over several months. When the settlement is arranged, the amount of debt forgiven should be classified as loss and charged off immediately under the Agencies' guidelines. (In certain cases, the Agencies allow for the establishment of a specific allowance.) Accounting for specific allowances varies between the Agencies. Institutions should consult their quarterly regulatory reporting instructions for guidance.

Loss Allowances

Accrued Interest and Fees. The allowance account should be adequate to cover not only principal balances, but also any related unpaid interest and fees. Although regulatory reporting instructions do not require consumer credit card loans to be placed on nonaccrual status based on delinquency, the Agencies are concerned that income be accurately measured and reported each period.

Delinquent and Nondelinquent Accounts. The allowance should be adequate to cover probable and estimable losses on both delinquent and nondelinquent loans, meaning all loans.

Special Circumstances. Institutions should ensure they consider the loss characteristics of those loans that may have special credit concerns such as overlimit accounts, accounts in workout programs, and accounts with negative amortization. For institutions with multiple workout programs, the institution may need to evaluate each program individually with respect to the adequacy of the allowance. The amount of analysis that is required will depend on the materiality of the amounts in the workout programs.

Recoveries. The only portion of future recoveries that can be credited to the allowance is the amount that was actually charged against the allowance. If an institution charges principal against the allowance, but charges unpaid interest and fees against their respective income accounts, subsequent recoveries may be credited to the allowance only up to the amount of the original charged-off principal. Recoveries in excess of such amounts would be credited to income.

Subprime

Throughout the guidance, the Agencies indicate their increased level of concern with subprime portfolios and subprime loans. As examples, certain overlimit policies that may be acceptable for prime borrowers may not be acceptable for subprime borrowers, and negative amortization policies on subprime accounts may be viewed as a greater credit risk than such policies on prime accounts. A significant problem experienced by institutions is the lack of substantive definitions of what comprises a subprime portfolio or subprime segment of a portfolio. While most in the industry look to the portfolio performance to determine whether a portfolio or segment is subprime, quite often the Agencies may base their determination on specific characteristics. It is important for institutions to have evaluated whether or not their loan programs are subprime or prime. As a further complication, the designation of subprime has at times been reduced to a credit rating score without looking beyond the scores to the portfolio performance. Credit rating scores, while helpful in evaluating certain types of expected behavior, are not by themselves indications of prime or subprime credit.

Documentation

An overall message is that documentation is important for everything from justification for credit line increases, to estimates of allowances, to explanations of policy exceptions. The lack of documentation can be viewed by the Agencies as an indication of a less than well-managed system.

Guidance

With respect to income recognition and loss allowance practices for credit card lending, the aforementioned guidance reflects GAAP, existing interagency policies on loss allowances, and current call report and thrift financial report instructions. Relevant GAAP guidance is provided in FASB Statement No. 5, *Accounting for Contingencies*, and in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*. Additional GAAP guidance is located in chapter 7 of the Audit and Accounting Guide *Banks and Savings Institutions*, and in SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, which provides guidance on accounting for delinquency fees, and recognition guidance for recoveries of previously charged-off loans.

Auditing guidance consists of SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78 and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). These standards describe the objectives and components of an entity's internal control and explain how an auditor should consider internal control in planning and performing an audit. In all audits, the auditor should obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation. In obtaining this understanding, the auditor considers how an entity's use of information technology (IT) and manual procedures may affect controls relevant to the audit. If operations are outsourced, SAS No. 70, as amended, provides guidance on the factors and clarifies applicability that an independent auditor should consider when auditing the financial statements of an entity that obtains services from another organization that are part of its information system.

Finally, any public institution, and nonpublic institutions with assets over $500 million and are subject to the reporting requirements of the FDIC Improvement Act of 1991 (FDICIA), will have to comply with the internal control requirements of Sarbanes-Oxley Section 404 as of June 30, 2004. See the Articles "Sarbanes-Oxley and Internal Audit" and "Compare and Contrast—Sarbanes-Oxley Section 404 and the FDIC Information Act of 1991" in the "In the Spotlight" section of this Alert for additional discussion. (Nonpublic institutions with assets of less than $500 million and not subject to the FDICIA are encouraged to follow the Sarbanes-Oxley Act's internal audit outsourcing prohibition.)

Loan Accounting Developments

Two AICPA Accounting Standards Executive Committee (AcSEC) SOP exposure drafts are outstanding that, if issued, will affect the accounting for loans. For a list of current accounting literature on loans, see the next article in this Alert. CPAs may want to familiarize themselves with the conceptual changes, similarities, overlaps, and applications of the two exposure drafts. The first exposure draft is entitled *Allowance for Credit Losses* (the *"Allowance"* SOP), and the second is entitled *Accounting for Loans and Certain Debt Securities Acquired in a Transfer* (the *"Purchased Loans"* SOP). (Particulars under the exposure drafts may change slightly prior to finalization.)

How would current accounting practice change under the proposed Allowance *SOP*?

The *Allowance* SOP addresses the recognition and measurement by creditors of the allowance for credit losses related to all loans, as that term is defined in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, with certain exceptions. The *Allowance* SOP deals with the components of the allowance for credit losses, individual loan impairment, collective loan impairment, and disclosures. A major issue is the timing of credit loss recognition. Practice difficulty exists in pinpointing the moment when loss is incurred. The *Allowance* SOP states that the institution should use incurred losses only instead of expected future losses. In short, institutions should avoid application of expected loss models to pools of loans and eliminate cushions in the reserve. Additionally, disclosures of credit data should be improved.

As an example, Emily took out a revolving farm business loan in 1999 with Emerald City Bank. Emily missed a number of payments over the past year and lost revolving privileges. Additionally, the bank was aware of property tornado damage since Emily took out a second mortgage to rebuild her home. The bank noted that Kansas statistics correlate high consumer loan default with inclement weather events.

Emerald City Bank uses an expected loss model to estimate Emily's pooled loan loss allowance, which may have contained "set aside" allowances. However, under the *Allowance* SOP, the loan allowance would now consist only of (*a*) a component for individual loan impairment pursuant to FASB Statement No. 114 and (*b*) one or more components of collective loan impairment pursuant to FASB Statement No. 5, *Accounting for Contingencies.*

Furthermore, the use of peer group data in calculating the allowance would no longer be permitted (unless Emily's loan was a brand new product type for the bank). Under current practice, Emerald City Bank uses peer group data on allowances as a tool, and thus can add additional amounts to the loan-loss reserve. Under the *Allowance* SOP, the bank would have to use its own individual loss experience and start with actual losses from past years. The bank would no longer be able to use Kansas' bank data to help estimate the loan allowance unless it entered into a new product for which it had no experience of its own.

Moreover, impairment in the pool that contains Emily's loan will need to be measured based on the present value (PV) of expected future cash flows but the assessment should include only those losses that have been incurred and not those expected to occur over the life of the loan—even if those losses are predictable. The estimate of loss in pools of loans should be an estimate of losses that have already been incurred, even if not yet identifiable, and not an estimate of losses that might be incurred over the remaining life of the loans, even if predictable based on historical experience. (That is, the allocations should not utilize a "life of the loan" concept, even if the future loss is predictable based on historical experience.) The bank may calculate the PV indirectly by measuring what will not be collected. The allocations for pools would now need to include actual loss rates adjusted, using relevant observable data, to existing conditions. The following are examples of the components representing the losses for pools and the associated observable data:

Example 1:

- *Component:* Historical charge-off experience for credit risk graded loans
- *Observable Data:* Charge-off data for the particular grade or industry group (in this case, farm business loans)

Example 2:

- *Component:* Historical charge-off experience for consumer loans grouped by payment status (30, 60, 90 days past due) (Emily's loan was at least 90 days past due)
- *Observable Data:* Charge-off data for the respective payment categories

Example 3:

- *Component:* Adjustment to historical charge-off experience for consumer loans affected by a change in bankruptcy rates
- *Observable data:* Publicly-available bankruptcy data (for Kansas consumers)

Note that allowances would now be required to be documented in similar fashion to Federal Financial Institutions Examination Council (FFIEC) policy requirements. The auditor of Emerald City Bank should ensure that employees are properly documenting and applying the aforementioned methodology.

Even though the bank is a nonpublic bank, it would be required, under the *Allowance* SOP, to increase its disclosures. New disclosures would include a general description of each significant component of the allowance, a breakdown of the allowance per loan, a description of the credit risk evaluation processes used for pools of loans, and a description of the observable data used in the measurement of the component. Additionally, a table is now required to show the breakdown of loan types and the determination and aggregation of loss allowances. This table needs to include:

- The recorded investment by credit risk grade.
- The recorded investment by payment status.

- The total allowance for credit losses by loan type. (This last requirement is inclusive of all loans.)

This new table is more expansive than current SEC requirements.

Excluded From Scope. The *Allowance* SOP does not apply to loans that are measured at fair value or at the lower of cost or fair value. It also does not apply to leases or debt securities or to short-term accounts receivables arising from the sale of goods and services, or to short-term loans that are unconditional promises to give to not-for-profit organizations. Additionally, it does not apply to security for a counterparty (security deposits) or to loans that are retained interests, which are addressed in FASB's Emerging Issues Task Force (EITF) Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*.

Audit Implications. The *Allowance* SOP would reaffirm and clarify rather than change GAAP in its application to allowances. Implementation may result in increased earnings volatility and may result in a reduction of the allowance. Additionally, there could be a lack of consistency among institutions in terms of disclosures. Auditing the required increased documentation may be labor-intensive. (However, the rule will probably not require significant logistical changes involving information technology systems at institutions.)

How would current accounting practice change under the proposed Purchased Loans *SOP*?

Unlike the *Allowance* SOP, the *Purchased Loans* SOP excludes originated loans from its scope, but applies to unhealthy purchased loans, whether individually, in a portfolio, or in acquisition (see list of scope exceptions at the end of this section). The *Purchased Loans* SOP updates Practice Bulletin (PB) No. 6, *Amortization of Discounts on Certain Acquired Loans*, for more recently issued literature, including FASB Statements No. 114, No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* Additionally, it addresses FASB Statement No. 91, *Accounting for Nonrefundable*

Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, which requires that discounts be recognized as an adjustment of yield over a loan's life.

As an example, Oz Bank acquires Emerald City Bank subsequent to Emily's borrowings. Under the *Purchased Loans* SOP, for all loans purchases with evidence of credit quality deterioration since origination, including those outside of a purchase business combination:

- Oz Bank will no longer display discounts on purchased loans in the balance sheet and will not carry over the allowance for loan losses previously established by Emerald City Bank.
- Oz Bank should display purchased loans at the initial investment amount on the balance sheet. Furthermore, income should be based on cash flows expected to be collected rather than on the contractual rate. (This prohibition also applies to purchases of unhealthy loans not included in a purchase business combination, examples of which include syndicated loans purchased in the secondary market and loans acquired in portfolio sales.)
- New disclosures will now be required, in addition to those already required by other accounting literature, including FASB Statements No. 5, No. 114, No. 115, and No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*.

Moreover, under the *Purchased Loans* SOP, Oz Bank needs to note if Emily's loan had evidence of credit quality deterioration since origination, which it does. Under the *Purchased Loans* SOP, all loans acquired with evidence of deterioration in credit quality since origination will need to be accounted for under a new method using an income recognition model. Oz Bank will need to estimate cash flows expected to be collected on the loan at purchase, and periodically thereafter. Cash flows expected in excess of the initial investment (purchase price) should be recognized as yield. Contractual cash flows in excess of expected collections should not be recognized as yield.

It should be noted that Oz Bank should use the same rules under the *Allowance* SOP that Emerald City Bank used for creating allowances for loans.

Scope Exclusions. Accounts excluded include both unhealthy and healthy (1) revolving credit accounts in which the customer has privileges at the purchase date (but does apply to accounts in which the customer has lost revolving privileges), (2) retained interests, (3) receivables from leases, (4) loans carried at fair value with changes in fair value included in earnings, and (5) mortgage loans that are held for sale (which are covered under FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*). Note that Emily's businesses loan is included in the scope since Emily lost revolving privileges prior to Oz Bank's acquisition. However, if her mortgage is held for sale, it will be excluded from the scope of the *Purchased Loans* SOP.

Audit Implications

Financial institutions will have to record the purchased loans with evidence of credit deterioration at the acquisition cost, and loan loss reserves are not to be carried over. (Current practice allows banks to record the loan at an amount other than the purchase price.). These changes will cause overall loans to increase but reserves will remain static, which will cause reserve-to-loan ratios to decline. The aforementioned projects will change the way financial institutions record and disclose one of the most important line items of the balance sheet. The auditor needs to recognize if one or both of the projects are being properly applied in various scenarios. Finally, the auditor will need to ensure that proper transition rules are applied.

Current Loan Guidance—Late 2003

The aforementioned section describes potential guidance which has not yet been finalized. Current practice for the measurement of the allowance for loan losses available to institutions includes the following:

- FASB Statements No. 5, *Accounting for Contingencies*, No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended by FASB Statement No.118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*

- EITF Topic D-80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio*
- FIN No. 14, *Reasonable Estimation of the Amount of a Loss (an Interpretation of FASB Statement No. 5)*
- SEC SAB No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*, and SEC Financial Reporting Release (FRR) No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*
- FFIEC Joint Interagency Policy Statement entitled *Allowance for Loan Loss and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions—2001*
- NCUA Interpretive Ruling and Policy Statement 02-3 on the Allowance for Loan and Lease Losses
- Joint Interagency Policy Statement on the Allowance for Loan and Lease Losses issued on December 21, 1993, by the SEC and the federal banking regulators (requires *nonpublic* financial institutions to follow instructions very similar to those outlined in FRR No. 28)
- SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*
- Audit and Accounting Guides *Banks and Savings Institutions, Audits of Credit Unions,* and *Audits of Finance Companies*
- SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*. SOP 01-6 reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by the aforementioned Guides. This SOP is currently being incorporated into a new Audit and Accounting Guide, which will supersede the three aforementioned Guides and is expected to be issued in 2004. See the SOP for effective date and transition information. Audi-

tors should read SOP 01-6 in conjunction with chapters 6 and 7 of the Audit and Accounting Guide B*anks and Savings Institutions*, chapters 5 and 6 of the Audit and Accounting Guide *Audits of Credit Unions*, and chapter 2 of the Audit and Accounting Guide *Audits of Finance Companies*, as applicable, for a thorough discussion of auditing procedures regarding loans and loan loss allowances.

A Look at Custodian Risk

With market yields at historically low levels, financial institutions have purchased a greater number of short-term liquid investments than in prior years. Stock market caution has made consumers increase deposits; many institutions are now rolling in liquidity. Institutions have purchased short-term liquid investments to ward off long-term low interest rate investments in case of an interest rate rise.

The credit risk for these investment transactions extends beyond the instrument issuer to the actions and judgment of the third party safekeeping the asset. Typically, financial institutions use third parties such as registered broker-dealers, commercial banks, or unregulated entities as custodians to hold portfolio assets. Each of these entities has custodial risk due to potential insolvency. Therefore, in addition to performing audit procedures that obtain valuation, existence, and ownership comfort on the assets themselves, it is important to evaluate the custodian. Some aspects a practitioner might consider to assess potential problem areas are as follows.

- *Is the majority of your client's portfolio invested with commercial banks or deposit brokers?* Commercial banks are governed by their respective regulatory agency. Registering with a deposit broker may increase risk because deposit brokers are not required to obtain *any* type of certification or to be registered with any government agency. (However, your analysis should be balanced with the knowledge that a well-capitalized broker-dealer with a proficient market reputation may represent a low risk compared to that of a vanilla commercial bank.)

- *Is your client's broker-dealer registered with the SEC?* If a broker-dealer is registered with an agency, it will be subject to the requirements and regulations of that agency.

- *If a broker-dealer was used, is the asset registered in the investing bank's name?* If so, the investor reduces the risk of a pro rata distribution.

- *Are custodian relationships diversified?* Institutions should be safekeeping assets at more than one broker-dealer (or other) custodian so that a sudden failure of any one firm will not expose an excessive level of assets to loss.

- *Did your client conduct a thorough independent objective review of custodians, or were custodians obtained via nepotism or "quid-pro-quo" business relationships?* The OCC recently stated that the "risk of loss from the failure of a custodian can potentially be very significant. Therefore, as in any relationship that involves credit risk, banks should conduct a thorough credit review of the financial strength of potential custodians before initiating a custodial relationship.

- *Did your client purchase the insured CDs directly from the issuing institution?* This lowers risk, as many broker-dealer "finders" do not have high capital resources and are at greater risk of default. Intermediary broker-dealers are indeed a valuable source for finding good investments at larger, more secure institutions, but not necessarily good for issuing investments.

Auditors are reminded that SAS No. 70, as amended, provides guidance on the factors and clarifies applicability that an independent auditor should consider when auditing the financial statements of an entity that obtains services from another organization that are part of its information system.

Attack on Predatory Lending: Implementation Changes to the Home Mortgage Disclosure Act

Predatory lending has been a hot topic among the federal regulators, not to mention plaintiffs' attorneys and consumer groups, for the past several years. In 2002, the Federal Reserve announced major changes to Regulation C, the implementing regulation to the Home Mortgage Disclosure Act (HMDA). The changes were so significant the Federal Reserve delayed the mandatory compliance date for most of the Regulation's amendments from January 1, 2003 to January 1, 2004.

Changes to the Regulation will require more types of lenders to report data and make more information available to the public and to fair lending examiners. Additionally, the Regulation will require lenders to use the most recent census information to report the location of the dwellings and to use the same collection format for race and gender as is gathered under other government programs.

(HMDA data is collected and reported to provide public and government officials with data that shows whether lenders are serving housing needs of their community locales. Additionally, the data helps public officials target public investment to promote private investment where needed. The data also assists in identifying discriminatory lending patterns and helps enforce antidiscrimination statutes.)

Changes to the HMDA are aimed at curbing potential predatory lending practices at financial institutions. If the following procedures are not being followed, portfolio credit risk may be compromised and audit scope should be evaluated. Information from this article can be incorporated into your testwork.

Some Changes for Financial Institution Processing

The institution will have to use new application forms for HMDA reportable credit requests—loans for the purpose of purchase, home improvement, or refinance of a dwelling. If data recording is automated, the company should inquire about the software provider's plans for 2004 HMDA reporting. Additionally, Human Resources should plan on necessary staff training for lending personnel collecting the information. Finally, the institution must be prepared to record the new information fields into the government-provided software and test the accuracy on a quarterly basis.

Specific Changes to Information Already Collected

Two changes took effect on January 1, 2003. First, the lending institution is now required to ask for racial and gender information for applications taken by telephone. The request was previously optional for telephone applications. Second, the institution must use the most recent census tract information. Failure to use this census tract information will cause the Loan Application Register (LAR) to be returned with errors. Census information is located on the FFIEC's Web Site at www.ffiec.gov.

The other changes taking effect January 1, 2004 may cause the institution to rethink its reporting strategy. If a closed-end loan is for the purpose of home purchase, refinance or improvement, it may be reportable. A loan for the purpose of purchasing a dwelling that is secured by a dwelling is reportable as a purchase. The definition of a home purchase loan has not changed; however, one aspect of recording the loan has. If the institution has made a first mortgage and a second mortgage at the same time on the same property, each transaction must be reported separately. The former rules allowed the lending institution to consider two transactions as one.

Currently, the regulation allows lenders to select from among several scenarios to determine whether the loan is a refinance. The new rule defines a refinancing as an application for a loan in which *both the existing and the new loan are secured by a lien on a dwelling*. To make this determination, the institution may rely on a borrower's statement about whether the loan being refinanced is dwelling-secured. The institution may determine to report all home equity loans when part of the proceeds is used to pay off a dwelling secured loan as a refinance.

There are now two definitions for "home improvement loan" that depend on whether the application is for a dwelling secured or not. If the loan is not secured by a dwelling, it is a home improvement loan if the customer says it is *and* the institution classifies it as such. For example, if the lending institution does not advertise a loan as a home improvement loan, the institution does not report the loan on the call report as a home improvement loan or the institution does not include a purpose code for home improvement on unsecured loans since it is not classifying loans as home improvement.

If an application is for a dwelling secured loan for the purpose of home improvement, it is reportable regardless of how the loan is classified by the institution.

The data collection requirements have also changed significantly. Applicants will be asked to select an ethnicity, either "Hispanic or Latino" or "Not Hispanic or Latino." Then, applicants are instructed to select one or more designations for race, for which five are listed.

New HMDA Requirements

If the financial institution has a "pre approval process," it will be required to indicate whether the customer's original application was a pre approval request, if that request was denied or results in an originated loan. The institution may, at its option, report applications that were not either accepted by the applicant, expressly withdrawn, or incomplete. The institution can have a "pre approval" process if a written commitment is issued to lend to creditworthy borrowers up to a specific amount and for a specific period of time, subject to limited conditions such as locating a suitable property. The institution may want to consider whether it provides pre approvals and, if so, how to include the information on the HMDA LAR.

The institution must designate "manufactured homes" on the LAR. The instructions refer to the federal building code for factory-built housing established by the Department of Housing and Urban Development (HUD). The HUD code generally requires that housing be essentially ready for occupancy upon leaving the factory and being transported to a building site. Modular homes that meet all of the HUD code standards are included in the definition because they are ready for occupancy upon leaving the factory. Other factory-built homes, such as panelized and precut homes, generally do not meet the HUD code because they require a significant amount of construction on site before they are ready for occupancy. Loans and applications relating to manufactured homes that do not meet the HUD code should not be identified as manufactured housing under HMDA.

The institution will report the lien status in 2004 for originated loans and for applications that do not result in originations.

The institution will have to report the spread between the annual percentage rate (APR) and the applicable Treasury yield on securities if the spread is equal to or greater than 3 percentage points for first-lien loans or 5 percentage points for subordinate-lien loans. To determine whether the rate spread meets this threshold, the institution should compare the Treasury yield for securities of a comparable period of maturity as of the 15th day of a given month, depending on when the interest rate was set, and use the APR for the loan as calculated and disclosed to the consumer. Again, the FFIEC has provided some tools on their Web Site to help the institution determine whether the rate spread must be reported (http://www.ffiec.gov/ratespread/default.aspx).

The institution must indicate whether the loan is subject to the Home Ownership and Equity Protection Act (HOEPA). A loan, excluding a purchase money loan or a Home Equity Line of Credit, is subject to the HOEPA if:

- For first-lien loans, the APR at consummation exceeds by more than 8 percentage points the yield on Treasury securities having comparable periods of maturity to the loan maturity; and
- For second-lien loans, the APR at consummation exceeds by more than 10 percentage points the yield on Treasury securities having comparable periods of maturity to the loan maturity.

or

- The total points and fees payable by the consumer at or before loan closing exceeds the greater of 8 percent of the total loan amount, or $400; the $400 figure shall be adjusted annually on January 1 by the annual percentage change in the Consumer Price Index that was reported on the preceding June 1.

Of course, reporting HOEPA loans on the LAR is secondary to providing the required disclosures when making a HOEPA loan. Many institutions, as a policy, choose to not make loans that would be subject to the rules.

Depending on how you count them, that's five additional fields to the LAR! That means five more opportunities for error. Therefore, a good HMDA Compliance program must include substantial training to avoid errors, testing to detect them before they are reported, and monitoring to prevent the same errors from recurring.

Housing's Hidden Liabilities

Over the past year housing sales continued to increase because of extraordinarily low interest rates, aggressive mortgage lending, and the sharp sell-off in the stock market, which left many consumers searching for safer investments.

Issues related to the potential impairment of mortgage-backed securities, mortgage-servicing rights, and credit quality are discussed in "The Margin Squeeze," "Capitalization and Valuation of Mortgage-Servicing Rights," and "Credit Quality Update" sections, respectively, of this Alert. However, other hidden housing liabilities could negatively impact your client's mortgage products, despite strong earnings.

Potential Housing Bubbles

The housing market has helped soften economic hardship in many major metropolitan areas. However, housing's benefits to the economy and financial institutions could ease in the months ahead. Housing prices are rising at a rate many economists believe is unsustainable; some geographic areas could experience a price correction analogous to the price correction of the 1990s stock market. Some reports indicate that New England home price appreciation may be unsustainable and that central California appreciation is beginning to slow. The Southwest and Mid Atlantic weak employment growth could invite a home sell-off, lowering market demand and prices. Additionally, New York, Chicago and Dallas have reported weakened housing demand in the past few months. Washington DC, Miami, Las

Vegas, and Los Angeles are also vulnerable. Regional banks are dependent on local economies. Therefore, if geographic housing bubbles burst, foreclosures and impaired assets could become more prominent.

Mold Everywhere

The toxic effect of mold has spread throughout the country, from California to the New York Island. Insurers are refusing to pay mold claims, and lenders are stuck with impaired property values. The problem has increased recently because materials used in new construction practices create a mold friendly environment. Many people will not purchase a home with mold due to allergies.

Your clients should be factoring mold into underwriting decisions and performing due diligence which includes periodic property inspections for the mortgages they finance. Contracts should ensure that the borrower is responsible for paying for mold damage. Proposals have been introduced in at least ten states increasing sellers' disclosure requirements for residential and commercial properties.

Skyrocketing Property Taxes

Property taxes are rising all over the country, even in small towns. Since state and local municipality revenues have decreased, governments have increased property taxes to close the gap. They have been able to do this since property taxes are directly tied to home market valuation. So far, consumers have been able to stay ahead of the increases by refinancing their homes at lower rates. However, an interest rate rise could increase costs for consumers and increase sales and foreclosures. Note that certain geographic areas (and individual neighborhoods) are protected by legal limits on property taxes. California has Proposition 13 and increases are capped at 2 percent; in Florida, 3 percent. However, in New York, Texas and Virginia, property taxes have been soaring.

Paperwork Volume

Some institutions have been overwhelmed with the volume of originations and refinancings; mortgage departments have not been able to keep up with the pace. Internal controls over the department may be lacking. For example, increased mortgage portfolio errors could exist with analysis, classification, and contractual agreements. Loan officers may be inexperienced. Additionally, customers could go elsewhere as many mortgages closed with higher than agreed-upon window rates brought on by paperwork delays.

Inaccurate Credit Scoring

The use of credit scores as a tool in the loan approval decision process has grown considerably over the past few years. As loan decisions become more automated, financial institutions are using credit scores to a greater extent to approve and determine the interest rate for consumer loans. Traditional underwriting and evaluations of customers' credit capacity are often relied on to a lesser extent, as credit scores become the predominant factor in the loan approval decision process. The auditor and management should thoroughly understand the impact of the credit scores in evaluating expected loan losses.

Assurance should be gained that the scoring system in use is reliable and has been properly validated. This should be done for both external systems and internally developed credit scoring systems. Management must have the capability to properly estimate the expected performance of each category of credit scores. System controls should be in place to capture and report relevant credit scoring information, including the ability to monitor performance by credit scores. Credit scoring can be inaccurately calculated. Old models may be used and other customer variables may be ignored.

Fraud and Illegal Activities

Money Laundering Update

Money laundering is the funneling of cash or other funds generated from illegal activities through legitimate businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national, or international jurisdictions.

Inadequate Controls Increase Risk of Money Laundering

Evidence suggests that financial institutions penetrated by money launderers may not have sufficient controls in place for effective money laundering risk management, including adequate processes for identifying unusual activity and determining whether unusual activity is really suspicious and reportable. In a number of instances, organized crime associates were employed at the affected institutions and existing controls were inadequate for management to detect suspicious or improper relationships and activities involving the criminals.

The USA PATRIOT Act

On October 26, 2001, President Bush signed into law the "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001" (the USA PATRIOT Act). This law, enacted in response to the terrorist attacks of September 11, 2001, was intended to strengthen our nation's ability to combat terrorism and prevent and detect money laundering activities in all financial institutions. Broad authority to develop anti-money regulations applicable to each of the various segments of the financial services industry was delegated to the Treasury Department. Financial institution regulators have passed the following rules to implement the Act.

- On September 26, 2002, the U.S. Department of the Treasury issued a final rule to implement Sections 313(a) and 319(b) of the Act. The rule adds sections 103.177 and 103.185 to the Bank Secrecy Act (BSA) regulations. The new sections are intended to prevent money laundering and terrorist financing through correspondent accounts maintained by U.S. financial institutions on behalf of foreign banks. The rule was effective October 28, 2002, and applies to correspondent accounts established after that date. Furthermore, on December 24, 2002, the Treasury Department amended this final rule and extended the time for collecting information from foreign banks to March 31, 2003.

- On September 26, 2002, the U.S. Department of the Treasury issued a final rule to implement Section 314 of the Act that adds sections 103.100 and 103.110 to the BSA regulations. These sections establish procedures that encourage information sharing between governmental authorities and financial institutions, and among financial institutions themselves.
- On June 9, 2003, the U.S. Department of the Treasury, the NCUA, the OCC, the OTS, the FRB, the FDIC, and the Financial Crimes Enforcement Network (FinCEN), issued a joint final rule to implement section 326 of the Act. Section 326 requires the Secretary of the Treasury (Secretary) to jointly prescribe with each of the Agencies, the SEC, and the Commodity Futures Trading Commission (CFTC), a regulation that, at a minimum, requires financial institutions to (*a*) implement reasonable procedures to verify the identity of any person seeking to open an account, to the extent reasonable and practicable, (*b*) maintain records of the information used to verify the person's identity, and (*c*) determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency. This final regulation applies to banks, savings associations, credit unions, private banks, and trust companies. The rule was issued by the regulators in April 2003 with an effective date of May 30, 2003. This "know your customer" compliance is needed by October 1, 2003.
- On July 23, 2003, the U.S. Treasury Department and FinCEN released an interim final rule providing guidance for bank compliance with section 312 of the USA PATRIOT Act. The rule also temporarily defers the application of section 312 for certain financial institutions, other than banks, pending issuance by the U.S. Treasury Department and FinCEN of the final rule. The interim final rule and section 312 became effective July 23, 2003, and the U.S. Treasury Department anticipates issuing a final rule no later than October 25, 2003. Section 312 requires U.S. fi-

nancial institutions to establish due-diligence policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts of foreign banks and private banking accounts of non-U.S. citizens.

Internal Audit Focus: Identity Theft

Simply put, identity theft is the use of another person's identification, credit, or other data that involves fraud or deception, and economic gain is realized in the name of the victim. Unlike fingerprints, which are unique to each individual, personal data, especially social security numbers, bank account or credit card numbers, telephone calling card numbers, and other valuable identifying data can be used.

Financial institutions use personal data for a variety of reasons and, unfortunately, criminals obtain personal and financial information from financial institution conduits such as Web sites and automated teller machine receipts. Financial institutions often shoulder large losses when identity thieves use credit cards, bank accounts, checks, or other venues. Identity theft is the fastest growing white-collar crime in the United States. Recent reports put the number of identity theft victims at 9.9 million per year. This represents approximately 5 percent of the adult population in America. Costs to financial institutions, business, and consumers have approached $50 billion annually.

Most of what is written about identity theft points toward the individual and what he or she can do to reduce the likelihood of being a victim to identity theft. However, the following provides insights and best practices to internal audit departments of financial institutions to help increase internal controls to reduce identity theft for its customers, employees, and to financial institutions themselves.

The Law

One of the keys to curbing identity theft lies in effective legislation designed to protect consumer rights, restrict access to personal information, and assist those who become victims of this crime to become whole again. Various financial institution regulators have recently addressed the growing need to control the problem associated with identity theft and have issued written guidance in this critical area. Congress addressed this concern with the passage of the Identity Theft and Assumption Deterrence Act of 1998. This Act supplemented existing laws that criminalize fraud by specifically addressing misappropriation of another's identity for criminal purposes.

The Gramm-Leach-Bliley Act (GLBA) directs federal financial institution agencies to review regulations and guidelines to ensure that financial institutions have policies, procedures, and controls in place to prevent and detect fraudulent access to such information. Additionally, several federal criminal statutes address illegal conduct associated with identity theft, including:

- The Federal Criminal Code (18 U.S.C. 1028), which makes it a crime to knowingly use, without lawful authority, a means of identification of another person with the intent to commit a crime.
- Sections 521 and 523 of the GLBA (15 U.S.C. 6821, 6823), which make it a crime to obtain customer information by means of false or fraudulent statements to an officer, employee, agent, or member of a financial institution.
- Sections 521 and 523 of the GLBA, which also make it a crime to request a third party to obtain customer information from a financial institution if the requester knows the information will be obtained through fraudulent methods.

The Fair Credit Reporting Act may get a makeover this year to possibly strengthen the safeguards in credit reporting. State laws vary widely. Californians, for instance, recently won the right to be promptly notified if the security of their credit data has been breached. Residents of six states—Massachusetts, New Jersey, Maryland, Vermont, Georgia and Colorado—have the right to receive a free credit report once a year.

Best Practices

What can financial institutions do to adequately protect customers, employees, and themselves from being victims of identity theft? Below are some internal control suggestions to consider when reviewing the institution's overall efforts to safeguard customer information and to deter identity theft. Although not all encompassing, the following can go a long way toward stemming the likelihood of identity theft from occurring.

Customer Information. To protect the financial institution's customers, the following steps should be considered to properly safeguard customer information:

- *New Accounts*—Verification procedures for new accounts should include, as appropriate, steps to ensure the accuracy and veracity of the application information. It should be noted that, from Section 326 of the USA PATRIOT Act pertaining to money laundering and terrorist acts, the Customer Identification Program (CIP) is required to be in place for financial institutions by October 2003.
- *Address Changes*—Adequate verification of address changes is necessary to reduce the likelihood of identity theft. Confirmation letters to the old address, or a simple callback to the phone number on file, can go a long way toward ensuring the validity of the change.
- *Loan Applicants*—A careful review of loan documents can detect irregularities that create "red flags" to identity theft. Is the social security number on the application different than on the credit report? Do the addresses differ on the loan documents? Do employer names differ?
- Conduct "systems penetration tests" to determine if systems are hacker proof. Filters, firewalls, encryption, authentication, and monitoring software are essential tools for information security.

- Provide training to all staff on security and privacy protection. This training should include part-time and temporary employees, along with vendors.
- Make it policy to assist customers when they are a victim of identity theft. Help them close accounts promptly and set up new accounts, cards, and checks. By providing help, goodwill is created between the customer and the financial institution. Related to this, provide customers with the ability to inspect and correct their personal data. This increases trust in your handling of their information and improves the accuracy of the information.
- Conduct criminal and civil background checks before hiring employees who will have access to personal information. This not only includes tellers, but also employees in the mailroom, facilities, and back office personnel as well.
- Prohibit using birth dates, social security numbers, or driver's license numbers as account or personal identifier numbers.
- Restrict system access to sensitive personal data to only those who need to know the information. Controlling system access capabilities is one of the foremost efforts in minimizing fraudulent activity.
- Adopt secure methods for the disposal of sensitive information. A strict policy should be in place that describes the methods to properly dispose of sensitive and confidential data. If third-party providers are used, ensure that an adequate contract is in place and that the vendor screens its employees, has adequate liability insurance, and follows prudent and acceptable procedures to dispose of your records. In addition, determine that the vendor's physical security methods are sufficient, and that they maintain accurate and current records to provide the necessary audit trails of destroyed records.
- *Physical security*—It is imperative to lock up sensitive and confidential information and restrict access to those without a need to know.

- Inform consumers of "Business Identity Theft," such as vandalized or mimicked Web sites. Mimic Web sites entice the financial institution customer to believe he or she is interacting online with the financial institution. Situations have been documented in which a fraudulent e-mail is sent from an individual posing as a financial institution employee. This unauthorized e-mail asks recipients to enter personal financial information on a Web site that is virtually identical to the Web site of the financial institution. The problem is that the fake e-mails and Web sites look so real that consumers frequently respond first and think about the possible consequences later. The institution needs to continuously educate its customers that financial institutions do not contact customers to request or verify security information. Further education should include a key to look in the Address toolbar in the browser. If it says anything other than the domain name of the site of the institution, it probably is a scam.
- Consider implementing the various fraud software products on the market today. This can allow the financial institution to regularly and periodically monitor and search its database, detect unusual financial patterns and activity, provide secured data on potential applicants to the financial institution, and verify existing identification provided by the customer. Fraud software comes in a variety of sophisticated means and costs that can help an institution reduce the likelihood of identity theft from occurring, or at least detect it in a timely manner.

Employee Information. A September 2003 report from TransUnion found that the single most underlying source of identity fraud is the theft of employer records. To protect the financial institution's employees, the following internal controls should be considered:

- Have a written privacy policy and mandate it as part of the new employee orientation. The policy should be posted in a conspicuous location, and ongoing training should take place.

- Lock up and limit access to personnel files, and minimize the types and amounts of data stored on employees.
- Provide a secure location for employees to store their purses, documents, briefcases, etc., at the workplace.
- Don't use social security numbers as employee identifiers, or on paychecks, time cards, staff badges, etc.
- Close external loopholes that can invite crime, such as employee names, e-mail addresses, and pictures on Web sites or annual reports.
- Consider using temporary employees only in areas where confidential information cannot be accessed.
- Toughen scrutiny of third-party vendors pertaining to personnel. Since it increases the number of people who will have access to personnel information, verify that vendors share your same commitment to protecting confidential employee data.

The explosive growth of identity theft is well publicized. Financial institutions have legal and business incentives to set up effective policies, procedures, methods and practices to keep information thieves from robbing their customer and employees in order to protect their customers, employees, and themselves from liability.

2003/04 Fraud Arena

Each year, specific environmental factors may increase certain fraud potentials. Below are certain indicators that might lead to fraudulent financial reporting and/or misappropriation of assets. This list is not all inclusive. More extensive information on additional fraud risk factors is included in the Practice Aid, *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (product no. 006613kk).

- Increases in competitor investment products that are similar to an institution's deposit products (for example, mutual funds, insurance annuities, and mortgage loans), leading to increased pressure on an institution's deposit rates

- Significant unexpected volatility (for example, foreign exchange rates, commodity prices, interest rate pressures) in financial markets where the institution has significant capital market presence
- Loss of customer base for small banks due to the current competition and loosening legislative restrictions on other financial institutions
- Unusually large growth or unusual profitability in a loan portfolio without a corresponding increase in the allowance for loan or lease losses
- Lack of compliance with numerous regulatory and capital requirements issued by regulators or other agencies
- Excessive reliance on wholesale funding (brokered deposits)
- Speculative use of derivatives and complex derivative transactions
- Problematic needs on meeting minimum capital adequacy requirements due to regulatory or accounting changes
- Increase in subprime and/or predatory lending in order to offset other areas of legislative concentration (such as special purpose entities (SPEs)/ variable interest entities (VIEs))
- Inadequate monitoring of controls due to changes in internal control structure necessitated by increased regulatory issuances
- Finalized transactions (such as payments) between Board or Audit Committee members due to termination of participants
- Lack of adequate reporting to the Board or Audit Committee due to transition of members
- Complex transactions that result in income or gains, such as sale and leasebacks, with arbitrarily short leaseback terms
- Lack of monitoring over numerous new employees hired to fill increased consumer demand (for example, loan departments)
- Change from an internal audit function that had been outsourced to the external auditor or other provider to a new

in-house internal audit department or another outsourcing provider (Sarbanes-Oxley requirement)

- Understaffed accounting or information technology department, inexperience or ineffective accounting or information technology personnel, or high turnover
- Adverse relationships between the institution and employees due to regulatory scrutiny and uncertainty surrounding the future of the institution
- Inadequate control over assets due to vacant branch manager positions
- Lack of board approval for significant loans or unusually high loan-officer approval limits. (Be alert to the existence of multiple loans being funded just below a loan officer's limit.)
- Approval for loans by newly-designated credit officers instead of just by loan officers.
- Relationships with clients that suggest potential tying
- A fragmented loan mortgage system in which loans are originated by brokers or loan officers funded by lenders and repeatedly sold in the secondary market without proper controls (such as loans purchased from loan brokers not being re-underwritten before purchase)
- Heavily automated underwriting systems with absent safeguards on appraisers and other small players

AICPA's Antifraud and Corporate Responsibility Resource Center

The AICPA's Antifraud and Corporate Responsibility Resource Center (www.aicpa.org/antifraud/) allows you to select optional ways to learn about fraud. As of this writing, spotlights are on the new Web-based fraud and ethics case studies and commentaries recently issued, the AICPA antifraud Web cast series, the interactive CPA course *Fraud and the CPA*, and a competency model that allows you to assess your overall skills and proficiencies as they relate to fraud prevention, detection, and investigation, among other topics. In addition, the site offers press releases and newsworthy items on other AICPA courses related to prevention and detection, and an overview of the AICPA antifraud and Corporate Responsibility Program.

In the Spotlight

Capitalization and Valuation of Mortgage-Servicing Rights

In the past year, as mortgage loan rates remained at an all-time low, there has been a steady increase in the number of financial institutions selling their new originations while retaining the servicing of conforming fixed-rate loans in the secondary market. By selling the loans, financial institutions are able to continue to service their customers without the risk of retaining low-interest, fixed-rate, long-term loans on their books in case of an interest rate rise. With the increase in sales also came the increase in the number of institutions selling their loans with servicing retained.

Due to this trend, more auditors have been faced with the challenge of auditing mortgage-servicing rights than ever before, and more financial institutions are being faced with the challenge of trying to record these assets in compliance with FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Although a book could be written about auditing all components of accounting for MSRs, this article will focus on common pitfalls seen with accounting for MSRs up front, during the initial capitalization stage, and ongoing, during subsequent impairment valuations. The assumption has been made that the auditor has already performed an evaluation to determine that the sale met the "true sale" requirements of FASB Statement No. 140 and a transfer of assets has occurred.

Common Pitfalls to Look for in Reviewing Initial Capitalization

Due to the complexity of accounting for mortgage-servicing rights, there are, unfortunately, several pitfalls one could encounter during the up front initial capitalization stage.

Failure to properly perform the relative fair value allocation. In accordance with FASB Statement No. 140, servicing assets retained in a sale should be initially measured by allocating the previous carrying amount between the loans sold and the mortgage-servicing rights retained, based on their relative fair values at the date of sale. Often, a financial institution will misinterpret or shortcut this step. The typical shortcut involves recording the mortgage-servicing rights at fair value without performing an allocation. Failure to perform the relative fair-value allocation will usually result in the overcapitalization of the mortgage-servicing rights.

Estimating the fair value of mortgage-servicing rights using unsupported shortcut methods. In order to properly record mortgage-servicing rights, one needs to be able to obtain a fair market value. In lieu of doing the work required to calculate and/or obtain a fair market value, financial institutions may be tempted, on occasion, to resort to unsupported shortcut methods. The most common shortcut is the application of a set percentage to the principal balance of the loans sold, such as 0.8 percent or 1 percent. In those instances, no documentation is usually maintained in support of the percentage factors.

Estimating the fair value of mortgage-servicing rights using an in-house spreadsheet model. While in-house modeling can be a valid method to calculate the fair value of mortgage-servicing rights, the risk of improperly calculating the value greatly increases and the auditor will, in most cases, need to increase audit test work, if material, to ensure that the valuation is not grossly misstated. The auditor should be sure to cover the following issues:

- Does the financial institution have the necessary expertise to be able to properly model the servicing rights in-house?
- Who developed the spreadsheet model?
- What are the main key assumptions being used in the valuation and are they consistent with those used by an independent broker?
- What are the sources of the assumptions and are they documented and updated in a timely manner?

- Is the financial institution using market-based or internally-derived assumptions?
- How is the model calculating the market valuation, and can the auditor reproduce the end calculation using similar assumptions?
- Is the final calculation prepared by the financial institution indicative of "true" market value, and has an independent broker valuation been performed to validate the reasonableness of the internal calculation?
- Does the institution obtain an independent appraisal?

Common Pitfalls to Look for in Reviewing Impairment Valuation

According to FASB Statement No. 140, an entity needs to subsequently evaluate and measure the servicing asset for impairment. During this stage, the auditor needs to be on the watch for several potential issues.

Failure to properly evaluate impairment at the strata level. An entity should have stratified its mortgage-servicing rights in accordance with the guidelines set forth in FASB Statement No. 140. The auditor needs to evaluate the impairment calculation to determine whether the financial institution stratified its mortgage-servicing rights and evaluated for impairment at the strata level. The risk exists that the financial institution may just assess impairment by comparing total book value of all mortgage-servicing rights against the total market value for the entire portfolio. This would result in a netting effect of any stratum with cushions against stratum with impairment, and is clearly prohibited in FASB Statement No. 140.

Writing up the mortgage-servicing rights asset in excess of book value. When an entity performs the impairment valuation at the strata level, care must be given to ensure that no strata is written up over book value. In other words, when comparing book value for a strata with its related market value, the financial institution cannot write up the asset to market value if market value is greater. The impairment valuation should result in the asset being recorded at the lower of cost or market.

Failure to properly value the mortgage-servicing rights using an in-house model. As noted above, sometimes an entity will attempt to value the mortgage-servicing rights in-house and the potential pitfalls noted earlier for in-house modeling during the capitalization stage also applies for the fair values calculated for use in the subsequent impairment valuations.

Caution in use of independent broker valuation. Often, an entity will choose to rely on an independent broker valuation for its fair market value quotes. In those cases, an auditor still has to be on the watch for the following:

- *Is the broker truly independent?* The auditor may have reason to question the independence of the broker if the financial institution consistently uses the broker for other services and the broker provides the valuation free of charge as a favor. The broker would have incentive to favorably value the servicing rights in order to maintain the broker-client relationship.
- *What assumptions were used by the broker?* In most cases, the assumptions used by the broker will be market based; however, the auditor will want to inquire whether the financial institution provided any input on the assumptions used by the broker in the calculation. Additionally, the auditor may want to consider obtaining a SAS No. 70 report.
- *Consistent use of broker valuations.* When the broker valuation is obtained, the broker will often not provide a set value but will provide a range of values with a midpoint fair value. The auditor should be alert to the consistency in which the financial institution selects the fair value for impairment valuation from the range. The entity should strive to be consistent with policies, and if it is determined that the midpoint range will be used, then consistency is key.

If the auditor questions the validity or independence of the broker valuation, a second independent broker valuation may be required.

Audit, Accounting and Regulatory Guidance

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, the AICPA Audit and Accounting Guides *Banks and Savings Institutions*, and *Audits of Credit Unions*, and SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, provide guidance related to mortgage-loan servicing. The aforementioned Guides and SOP will be combined into a combined AICPA Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies*, to be issued in early 2004.

Additionally, the FASB published a Special Report on February 15, 2001, that addresses the most frequently asked questions about FASB Statement No. 140. On April 19, 2001, the FASB staff published a set of questions and answers about isolation of financial assets transferred by banks and other entities, focusing on rights of redemption. On August 7, 2001, the FASB staff published a set of questions and answers about the limitations on the activities of a qualifying special-purpose entity (QSPE) set forth in paragraphs 35 through 44 of FASB Statement No. 140. Moreover, the FASB issued an exposure draft entitled *Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140* to further define the parameters of FASB Statement No. 140. Additionally, on February 24, 2003, the FDIC, the OCC, the FRB, and the OTS jointly issued "Interagency Advisory on Mortgage Banking," which highlights concerns and provides guidance regarding mortgage-banking activities, primarily in the valuation and hedging of mortgage-servicing assets.

For those institutions that have mortgage-servicing operations, the auditor should evaluate whether the institution is complying with the relevant accounting requirements. The auditor should gain assurance that the financial institution is properly recording the asset (or liability) and gain or loss on sale when loans are sold with servicing retained. Assurances should also be made that the institution is properly amortizing the mortgage-servicing rights and that procedures are in place to properly assess fair value for potential impairment.

Additionally, the various mortgage-related entities such as the Department of Housing and Urban Development (HUD), FNMA, Freddie Mac, and Government National Mortgage Association (GNMA, also known as Ginnie Mae), have various audit and reporting requirements.

Apart from the proper accounting treatment for loans sold, and accounting for retained servicing, the auditor may also want to evaluate the internal control of the servicing operations. The financial institution will have numerous financial and compliance obligations and responsibilities, such as (*a*) collecting and remitting loan payments, (*b*) ensuring compliance with federal and state regulations covering escrow accounts and other servicing requirements, (*c*) compliance with the seller servicing agreement with a third party such as Fannie Mae and Freddie Mac, (*d*) properly collecting on delinquent accounts, and (*e*) collecting and paying taxes and insurance. Failure to properly comply with any of these requirements could have serious financial impact on the financial institution.

Additional FASB Statement No. 140 Auditing Considerations

For clarity, the aforementioned mortgage-servicing rights discussion assumes that the two-step isolation criteria described in FASB Statement No. 140 have been properly met. It is important for the auditor to be cognizant that some clients may be selling loans in single-step transactions with continued involvement while at the same time derecognizing the related assets and liabilities. Paragraph 9 of FASB Statement No. 140 provides specific conditions under which control is considered to be surrendered. One such condition is that the transferred assets have been isolated from the transferor and put beyond the reach of creditors, even in bankruptcy or receivership. Since this condition is a legal isolation, the use of a legal interpretation as evidential matter to support management's assertion that a transfer has met the isolation criteria, may be required. In that case, the auditor can refer to Auditing Interpretation No. 1, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criteria in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140," of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 9336.01-.21).

In a minority of situations, legal interpretation may not be needed. Paragraph .05 of Interpretation No. 1 of SAS No. 73 states that "use of a legal specialist may not be necessary to obtain competent evidential matter to support management's assertion that the isolation criterion is met in certain situations, such as when there is a routine transfer of financial assets that does not result in any continuing involvement by the transferor." The Interpretation's related footnote 4 in paragraph .05 references EITF Topic D-99, *Questions and Answers Related to Servicing Activities in a Qualifying Special-Purpose Entity Under FASB Statement No. 140*, for guidance on the meaning of "no continuing involvement." However, it is important to note that many isolation transfers do not meet this "no further involvement of any kind" criteria. The auditor should discuss with clients the importance of obtaining a legal opinion to support isolation criteria.

Technology News—ACH

Reliance on technology causes risks such as increased complexities, access to member account information, and reliance on an outsider for transaction processing. The risks are further compounded if the services provided involve the use of the Internet because of the potential for individuals outside of the financial institution to access information and potentially perform unauthorized transactions.

Automatic Clearing House (ACH) transactions are flourishing in today's electronic environment. However, these transactions expose an institution to financial losses. Commercial ACH entries are not allowed to be returned as unauthorized outside of a 24-hour return period because financial institutions end up absorbing the losses. If a small institution is dealing with a large institution, the small institution may have to absorb the loss, as large institutions have large departments that understand and carefully monitor ACH rules and transactions.

Additionally, institutions initiating a debit transaction are liable to customers for the transaction on the theory that they should make the appropriate verification prior to purchase. Fraudsters have figured out that they can supply a checking account and bank routing number by phone or internet and authorize the initiation of an ACH debit from retailers that allow consumers to pay by direct debit.

Finally, every year the National Automated Clearinghouse Association creates new Standard Entry Classcodes to make ACH processing more efficient. These changes increase the likelihood of processing errors.

Some Auditing Considerations

If your client has ACH transactions, your internal control planning may need to address a number of factors. Procedures at the institution need to be in place to ensure that expanding relationships are well controlled. The security of information, privacy of members, and assurance that you are dealing with an ongoing solid entity is extremely important. Management should have a risk management program in place. Ongoing due diligence review and ACH oversight is paramount.

Transaction contracts should adequately protect the institution's legal interests. Contracts should be reviewed periodically by client's internal counsel. The contract should also outline duties, obligations, and responsibilities of the parties involved.

There should be segregation of duties between initiation and data entry of transactions. Data entry employees should be familiar with procedures so as to recognize any potential problems. Written procedures should exist for employees who process new accounts and handle ACH payments. ACH department managers should be knowledgeable and have enough time to properly supervise the department. Security measures should be in place to prevent authorized access to the ACH system and the system should verify each element entered. Procedures need to exist for repetitive transfers such as in the case of a deceased client.

Finally, the auditor may want to note if customers are notified of transactions in an independent manner outside the transmission system. Are the identities of new customers verified? There should be proper controls in place for hard copy transfer forms, and customer verification should be obtained. Finally, the control process over any returned ACH items, and the accounting procedures surrounding corresponding suspense accounts, may need to be examined.

Guidance

SAS No. 55, as amended, includes pertinent auditing guidance on internal control as it relates to technology. If operations are outsourced, SAS No. 70, as amended, provides guidance on the factors and clarifies applicability that an independent auditor should consider when auditing the financial statements of an entity that obtains services from another organization that are part of its information system. Moreover, the OCC issued Bulletin 2001-47 and the NCUA issued Letter 01-CU-20 entitled "Due Diligence Over Third Party Service Providers," which provide additional third party guidance.

Interagency Statement—Sarbanes-Oxley and Internal Audit

In response to the Sarbanes-Oxley Act of 2002, the regulators issued a much-anticipated revised policy, *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing*, on March 17, 2003. This policy replaces the December 22, 1997 policy and brings some clarity to an area that has been filled with confusion over the last several months.

The updated policy statement accomplishes several objectives. First, it reflects the regulators' experience since the issuance of the prior 1997 policy and outlines their expectations regarding internal auditing, regardless of whether it is in-house or outsourced. Secondly, this policy updates the guidance in light of the Sarbanes-Oxley Act. The policy also reminds boards and senior management of their responsibility for the internal audit function and reiterates the importance of independent review of internal controls. Finally, the policy statement also provides examination guidance for examiners evaluating the adequacy of the internal audit function.

What Has Changed?

The basic tenets of the policy statement have not changed. In fact, most of the guidance is intended to clarify certain existing policies and to define how the Sarbanes-Oxley Act and recently issued implementing SEC rules will apply to nonpublic institutions. One new requirement, however, is that each audit committee should establish and maintain procedures for employees to submit concerns, confidentially and anonymously, to the committee about questionable accounting, internal accounting control, or auditing matters. In addition, the audit committee should establish procedures for the timely investigation of complaints received and record retention, for a reasonable time frame, concerning the complaint and its subsequent resolution.

Part I—Internal Audit

It may appear that the regulators are placing more emphasis on the importance of internal audit. However, this is not a new focus—the audit committee should oversee the internal control structure. The audit committee should also oversee the internal audit function and evaluate its performance. The day-to-day responsibility for managing the internal audit function should be assigned to a member of management who understands the function and has no responsibility for internal control operation. The ideal organizational arrangement is for the manager to report directly and solely to the audit committee regarding both audit issues and administrative matters, such as resources, budget, appraisals, and compensation. If an institution chooses to have a dual reporting structure (Internal Audit reports functionally to the audit committee and administratively to another member of senior management), the audit committee should weigh the risk of diminished independence against the benefit of reduced administrative burden.

Management, staffing, and audit quality. The designated manager is responsible for control risk assessments, audit plans, audit programs, and audit reports. Ideally, the internal audit function's only role should be to independently and objectively evaluate and report on the effectiveness of an institution's risk management, control, and governance processes. As the complexity of financial institutions increases, it is extremely important that the internal audit function be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the operations and assess whether internal controls are effective.

Scope. The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution. At least annually, the audit committee should review and approve internal audit's control risk assessment and the scope of the audit plan. It should also periodically review internal audit's adherence to the audit plan and the need to expand coverage.

Communication. To properly carry out their responsibility for internal control, directors and senior management should encourage communication and critical examination of issues to better understand the importance and severity of internal control weaknesses. Furthermore, each audit committee should establish and maintain procedures for employees to submit concerns to the committee about questionable accounting, internal accounting control, or auditing matters.

Contingency Planning. The institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas.

The policy acknowledges that smaller institutions may have different circumstances. Each institution should have an internal audit function that is appropriate to its size and the nature of its activities. The procedures assigned to this function should include adequate testing and review of internal controls and information systems. The audit committee and management should carefully consider the extent of auditing that will effectively monitor the internal control system after taking into account the internal audit function's costs and benefits. For small institutions with few employees and less complex operations, these costs may outweigh the benefits. Nevertheless, a small institution without an internal auditor can ensure that it maintains an objective internal audit function by implementing independent reviews of significant internal controls, and the policy offers some suggestions on how to accomplish that goal.

Part II—Internal Audit Outsourcing Arrangements

Arrangements vary from outsourcing all procedures to only performing tests of areas requiring more technical expertise. Typically, a manager is designated to oversee the activities of the third-party provider. While the outsourcing firm may assist in determining risks to be reviewed and recommend testing procedures, the designated manager is responsible for approving the audit scope, plan, and procedures to be performed. Furthermore, the designated manager is responsible for the results of the outsourced audit work, including findings, conclusions, and recommendations. Of course, the board of directors and senior management must maintain ownership of the internal audit function and provide active oversight. The policy offers considerations for the board of directors and senior management in deciding to outsource.

Part III—Independence

This part of the policy statement relates only to an outsourcing arrangement in which an audit firm provides both external and internal audit services to an institution in one of the following categories:

Public Companies. On January 22, 2003, the SEC adopted final rules implementing nonaudit service prohibitions and audit committee preapproval requirements. According to these rules, an audit firm is not independent if it provides certain prohibited nonaudit services to a public company audit client. These rules generally become effective on May 6, 2003, with a one-year transition period.

Institutions Subject to Section 36 of the FDICIA. Each FDIC-insured depository institution with total assets of $500 million or more is required to have an annual audit. Regardless of whether or not the institution is a public company, the external audit firm must comply with the SEC's auditor independence requirements.

Nonpublic Institutions Not Subject to Section 36. While the agencies encourage voluntary compliance with SEC independence rules, they also believe that a small (less than $500 million in assets), nonpublic institution with less complex operations and limited staff can, in certain circumstances, use the same firm to perform both the external audit and some or all of the institution's internal audit activities. The agencies encourage, but do not require, all institutions to follow the prohibited services of the Sarbanes-Oxley Act.

Part IV—Examiner Guidance

Consistent with the prior policy, examiners should have full and timely access to an institution's internal audit resources, including personnel, workpapers, risk assessments, work plans, programs, reports, and budgets. Examiners will assess the quality and scope of an institution's internal audit function, regardless of whether it is performed by the institution's employees or outsourced. The policy statement outlines specific items to be evaluated by examiners and defines steps to be taken if they have concerns about adequacy of internal audit or the independence of the outsourcing provider.

This Financial Institution Letter FIL-21-2003 replaces FIL-133-97, dated December 22, 1997. The full-text may be downloaded at http://www.fdic.gov/news/news/financial/2003/fil0321.html.

Compare and Contrast—Sarbanes-Oxley Section 404 and the FDIC Information Act of 1991

Effective August 14, 2003, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, the SEC adopted rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting. This rule change represents a myriad of additional responsibilities for financial institutions and their auditors.

Section 404(a)

Section 404(a) of the Act mandates that registrants (1) take responsibility for establishing and maintaining adequate internal control structure and procedures and (2) assess their effectiveness at the end of each fiscal year. Management must create a newly required "Management's Annual Internal Control Report" as part of the Annual Report. (Quarterly updating is necessary only if the internal control environment has changed or is likely to change materially.)

The new report needs to contain the following:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company
- A statement identifying the framework used by management to evaluate the effectiveness of this internal control
- Management's assessment of the effectiveness of internal control as of the end of the company's most recent fiscal year
- Disclosure of any material weaknesses
- A statement that its auditor has issued an attestation report on management's assessment (The company must include this report in the company's annual report.)

The SEC coordinated with the FDIC to eliminate any unnecessary duplication between the aforementioned requirements and Section 36 of the FDICIA. Many internal control requirements of the Sarbanes-Oxley Act were structured after the FDICIA. A comparison of Sarbanes-Oxley and the FDICIA Management Requirements is indicated below for clarity.

Sarbanes-Oxley	*FDICIA*
A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company	A statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting

Sarbanes-Oxley	*FDICIA*
Not required by Sarbanes-Oxley	A statement of management's responsibility for preparing the institution's financial statements
Not required by Sarbanes-Oxley	A statement of management's responsibility to comply with designated laws and regulations relating to safety and soundness
A statement identifying the framework used by management to evaluate the effectiveness of this internal control	Not required by FDICIA. (The FDIC's regulations do not specifically require that management identify the control framework used to evaluate the effectiveness of the institution's internal control over financial reporting. However, given certain attest requirements, the FDIC believes that the framework used must be disclosed or otherwise be publicly available to all users of reports that institutions file with the FDIC pursuant to part 363 of the FDIC's regulations.)
Management's assessment of the effectiveness of internal control as of the end of the company's most recent fiscal year	Management's assessment of the effectiveness of the institution's internal control structure and procedures for financial reporting as of the end of the fiscal year
Disclosure of any material weakness (and the related stipulation that management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses)	Not required by FDICIA
A statement that a registered public accounting firm has issued an attestation report on management's assessment	Not required by FDICIA
Inclusion of the registered public accounting firm's attestation report on management's assessment in the Annual Report	Not required by FDICIA. (The FDIC's regulations do require an independent public accountant to examine, attest to, and report separately on, the assertion of management concerning the institution's internal control structure and procedures for financial reporting, but these regulations do not require the accountant to be a registered public accounting firm.)

Insured depository institutions that are subject to part 363 of the FDIC's regulations (as well as holding companies permitted to file an internal control report on behalf of their insured depository institution subsidiaries in satisfaction of the FDIC and SEC regulations) can choose to either prepare two separate management reports to satisfy the FDIC and SEC requirements or prepare a single management report that satisfies both requirements.

If a single report is prepared, it must contain the following combined requirements of the above chart:

- A statement of management's responsibility for preparing the registrant's annual financial statements, for establishing and maintaining adequate internal control over financial reporting for the registrant, and for the institution's compliance with laws and regulations relating to safety and soundness designated by the FDIC and the appropriate federal banking agencies
- A statement identifying the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting as required by the Exchange Act Rule 13a-15 or Rule 15d-15
- Management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not management has concluded that the registrant's internal control over financial reporting is effective, and of the institution's compliance with the designated safety and soundness laws and regulations during the fiscal year. This discussion must include disclosure of any material weakness in the registrant's internal control over financial reporting identified by management
- A statement that the registered public accounting firm that audited the financial statements, included in the registrant's annual report, has issued an attestation report on management's assessment of the registrant's internal control over financial reporting

Finally, it is important to note that the institution or holding company will have to provide the registered public accounting firm's attestation report on management's assessment in its annual report filed under the Exchange Act. For purposes of the report of management and the attestation report, financial reporting must encompass both financial statements prepared in accordance with GAAP and those prepared for regulatory reporting purposes.

Section 404(b)

Section 404(b) of the Act requires the external auditor to attest to, and publicly report on, management's assessments of the effectiveness of the company's internal controls and procedures for financial reporting. Auditors are expected to expand their scope in relation to internal control. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Public Company Accounting Oversight Board (PCAOB). (As of the writing of this Alert, the PCAOB has issued Release No. 2003-017, *Proposed Auditing Standard—An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.*) The rule says any such attestation shall not be the subject of a separate engagement. In the past, auditors did not usually identify internal control weaknesses in their audit reports unless the weakness was material. Instead, they would be in the form of "management letters," which were not required to be disclosed to the public.

Section 404 does not specify where the management report should appear. However, there is a preference that companies should place the report on internal controls close to the corresponding attestation report issued by the auditors. Positioning the report near the company's Management's Discussion and Analysis disclosure or immediately preceding the company's financial statements would be two appropriate locations.

Effective Dates

There are changes to section 302 and section 906 certifications effective for Form 10-Qs due August 14, 2003. Accelerated filers under Rule 12b-2 must comply with new requirements, as of the end of the first fiscal year ending on or after June 15, 2004, for the management report on internal control. For nonaccelerated filers (market capitalization less than 75 million), the deadline is the first fiscal year ending on or after April 15, 2005. Section 302 requires detailed certifications as to the design, establishment, maintenance, and effectiveness of the internal controls. The certifications required by Sections 302 and 906 will be part of the list of required exhibits to be included in reports filed with the SEC.

FIN No. 46 and Financial Institutions

FIN No. 46, *Consolidation of Variable Interest Entities, an interpretation of ARB No. 51*, was issued to address consolidation by business enterprises of entities to which the usual condition of consolidation described in ARB No. 51, *Consolidated Financial Statements*, does not apply because either the equity investors in an entity (1) do not have the characteristics of a controlling financial interest or (2) do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. An entity lacking one of these characteristics is referred to as a variable interest entity. FIN No. 46 governs how institutions should assess interests in other entities in determining whether to consolidate (or deconsolidate) that entity. The following terms will help you understand FIN No. 46.

- A ***variable interest*** is a contractual or ownership interest in an entity that changes when the value of the entity's net assets changes.
- A ***variable interest entity (VIE)*** is an entity in which either the controlling financial interests are not voting interests, or the equity investors do not have sufficient equity to absorb the expected losses of an entity.
- A ***primary beneficiary*** is the party that, through a variable interest (or combination of variable interests), absorbs the majority of a VIE's expected losses or expected residual returns.
- ***Expected losses and expected residual returns*** refer to amounts derived from expected cash flows as described in

FASB Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. However, expected losses and expected residual returns refer to amounts discounted and otherwise adjusted for market factors and assumptions rather than to undiscounted cash flow estimates. Paragraph 8 of FIN No. 46 specifies which amounts are to be considered in determining expected losses and expected residual returns of a VIE. (***Expected variability*** is the sum of the absolute values of the expected residual return and the expected loss.) All three concepts are illustrated in Appendix A to FIN No. 46.

FIN No. 46 requires an assessment of every relationship between an enterprise and another legal entity. Legal entities include grantor trusts, limited liability corporations, partnerships, corporations, and other trusts. In applying FIN No. 46, the first step is to determine whether a legal entity is a VIE. The second step is to determine the primary beneficiary, if any. The primary beneficiary of the VIE is the party that must consolidate a VIE.

Entities are subject to consolidation under the provisions of FIN No. 46 (i.e., they are VIEs) unless:

a. One or more independent owners bear the substantive risks and rewards of ownership.

b. The independent owner(s) actually exercise(s) control as defined by FIN No. 46 in the following manner:

— The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights.

— The obligation to absorb the expected losses of the entity, which makes it possible for the entity to finance its activities, if they occur.

— The right to receive the expected residual returns, which is the compensation for the risk of absorbing the expected losses, of the entity if they occur.

Financial institutions will often have VIEs that are created for a specified purpose, for example, to facilitate leasing, securitization, hedging, research and development, and reinsurance. FIN No. 46

may have a large impact for large and mid-sized financial institutions since adding assets and debt back on the balance sheet will increase capital levels. Small institutions may not have many VIEs; however, they may appear in other forms, such as in the area of trust preferred securities (TPSs), which will now reduce rather than increase capital if lawmakers decide to include them under FIN No. 46. (On July 2, 2003, the Federal Reserve issued Supervisory Release 03-13, *Instructions for Reporting Trust Preferred Securities on Schedule HC-R of the FR Y-9C*, announcing that TPSs should continue to be counted as Tier 1 capital.) Note that asset-backed or mortgage-backed securities are exempt from the accounting board's rule unless the holder of the security has the unilateral ability to cause the entity to liquidate or to change the entity such that it no longer meets the criteria of paragraph 25 or 35 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Other areas, however, including synthetic leases, asset-backed commercial paper conduits, and collateralized debt obligations are affected.

Some scenarios to be on the lookout for are described in the next sections.

Lease Scenario

A Simple Real Estate Synthetic Lease. A synthetic lease is a financing structured to be treated as a lease for accounting purposes and a loan for tax purposes. A company (C) sells a building to a Lender's (L) independent leasing entity (the VIE). The VIE holds the title and leases it back to C. Question, who must consolidate the assets and liabilities under FIN No. 46?

In the past, lessee C kept the assets and liabilities off the books. This formerly attractive off-balance-sheet financing (in place of C issuing its own bonds or stock) may no longer qualify for off-balance-sheet treatment, and the demand for synthetic leases may decline as synthetic lease tenants convert to alternative lease structures. Under FIN No. 46, each variable interest holder must evaluate whether the entity is a VIE and if so, their respective primary beneficiary status. Accordingly, the financier (L), the lessee

C, or other parties to the transaction each holds a variable interest that must carefully analyze the VIE (which may consist of many different investments or may only be one investment) to see if it needs to consolidate the VIE. Note that a financial institution may hold any of the roles in a synthetic lease (including being the lessee) and needs to carefully evaluate each transaction under FIN No. 46.

An entity may be characterized as a VIE under FIN No. 46 because of one of the following situations:

- A party that does not have equity at risk has decision making authority.
- A party other than a holder of equity at risk directly or indirectly absorbs the expected losses (for example, the provider of a residual value guarantee in the lease scenario above absorbs expected losses).
- The right of the equity at risk holders to receive the expected residual returns is capped. For example, the lessee in the aforementioned leasing example might have a fixed-price purchase option that permits it the option to buy the property at a future date at a predetermined price. This feature allows the lessee to benefit from any appreciation in the property and thus takes the expected residual return from the equity at risk holders.
- The equity at risk may not be sufficient to absorb the expected losses of the entity. For example, if the amount of equity at risk is less than the computed expected losses.

The computation of expected losses and expected residual returns requires modeling of individual cash flow scenarios and the probability of each scenario occurring. The sum of the probability weighted present value of the cash flows from all the scenarios (which is the fair value) can then be used to determine the expected losses or expected residual returns that occur under each scenario and in total. The expected loss or expected residual return of a scenario is determined by multiplying the probability of a given scenario by the difference between the present value of the cash flow for that scenario and the present value of the probability weighted cash flows of all scenarios. Unfortunately, even for single asset leasing scenarios such as those described above, the analysis and computation can become very complex.

In anticipation of the issuance of FIN No. 46, many financial institutions have restructured their leasing entities and many synthetic leases have been unwound.

FIN No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, addresses proper accounting of guarantees typically used in synthetic leasing structures. Guarantees entered into after December 31, 2002, are subject to the new accounting rules. FIN No. 45 must be used in conjunction with FIN No. 46 when analyzing off-balance-sheet financings.

Asset-Backed Commercial Paper and Collateralized Bond/Loan Obligations

Many commercial paper conduits may need to be consolidated under FIN No. 46. A conduit occurs when a client gives the institution an asset (for example, a receivable) that is used to back short-term borrowings from commercial paper investors. Traditional asset-backed commercial paper conduits will have to be consolidated by the institutions receiving the decision making fees unless they can be restructured. Additionally, FIN No. 46 provisions make it more likely that existing collateralized debt obligations will need to be consolidated. In the absence of a majority equity investor, the collateral manager is likely to be identified as the primary beneficiary of a VIE and will thus be required to consolidate the collateralized debt obligation.

FIN No. 46 does not apply to the transferor of a qualified special-purpose entity covered by paragraph 35 of FASB Statement No. 140, or to grandfathered special-purpose entities. (Note that the FASB has decided to increase the severity of FASB Statement No. 140 criteria and has issued an exposure draft entitled *Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140*. See the "Accounting Pipeline" section of this Alert for more information.) While this exception is a major relief for many securitization transactions, the problem of consolidation exists in cases when the SPE does not qualify under FASB Statement No. 140. Common examples of qualified special-purpose entities include securitized auto loans and credit card receivables.

Other Areas That May Require VIE Consolidation

There are many possible relationships an enterprise may have with other legal entities that are VIEs. For example, a company may participate in joint ventures with outside investors that may be VIEs. Swap agreements and derivative instruments between entities, even if used for hedging purposes, need to be evaluated. Financial institutions need to evaluate equity method investments, leases, trust accounts, and loans as potential relationships with a VIE that may trigger consolidation. Real estate limited partnerships, including affordable housing partnerships are examples. Some institutions may find that depending on the specific facts, a debt restructuring could result in an institution consolidating a borrower.

Trust Preferred Securities (TPSs)—Potential Deconsolidation

Much of the focus of FIN No. 46 is on consolidation of entities that previously were off balance sheet. However, the guidance in FIN No. 46 must also be applied to entities that were previously consolidated. In some cases, this will result in deconsolidation, as the primary beneficiary is an entity other than the party with the majority voting control. When the FIN No. 46 criteria are applied to many typical TPS structures, deconsolidation may result.

What are TPSs? Up until now, TPSs have been hybrid debt and equity instruments. A financial institution (Bank Holding Company [BHC]) creates a trust (the VIE) and buys 100 percent of its common stock. The VIE issues preferred securities to outside investors, takes the cash from the sale of TPSs and the common stock, and lends the cash back to the BHC in the form of junior subordinated debt under similar terms as the preferred securities. TPSs have historically been recorded on BHC's books as a redeemable security that is either classified as debt or mezzanine with the common equity eliminated in consolidation.

Since the party that absorbs the majority of the expected losses or receives a majority of the expected residual returns is the only party that may consolidate a VIE, voting ownership no longer determines consolidation for many entities. (The risk and rewards model now takes priority over the control model.) The BHC's 100 percent common stock ownership of the trust may no longer be the determining factor because it does not represent equity at risk, as its common stock was acquired by providing a subordinate note (the BHC does not have any risk of loss). For TPSs, the outside preferred stock investors may bear the majority of the expected losses as a group. Accordingly, the BHC would no longer consolidate the entity on its books if it does not absorb a majority of the expected losses or receive the majority of the expected residual returns. If deconsolidation occurs, the subordinate debt will be reflected as a liability of the BHC.

Hedging of TPSs. Many TPSs were already classified as liabilities and hedged under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.* Upon deconsolidation as a result of applying FIN No. 46, an issue was created regarding the loss of hedge accounting. The FASB issued Derivative Implementation Group Issue No. G24, *Cash Flow Hedges: Accounting for the Discontinuance of Hedging Relationships Arising From Changes in Consolidation Practices Due to Initially Applying FASB Interpretation No. 46*, which provides guidance that allows re-designation of derivatives that were hedging TPSs, classified as liabilities prior to the adoption of FIN No. 46, to the remaining subordinated debt. This allows hedge accounting to effectively be continued.

Capital Treatment. As stated earlier in Supervisory Release 03-13, *Instructions for Reporting Trust Preferred Securities on Schedule HC-R of the FR Y-9C*, the Federal Reserve has stated that organizations should continue to include TPSs as tier 1 capital for regulatory purposes, together with other cumulative preferred stock, to the 25 percent of tier 1 capital limit, until notice is given to the contrary. However, this practice may change in the future. Practitioners should remain abreast of any developments.

Additional Issues for TPSs. Moreover, due to the passage of FASB Statement No. 150, *Accounting for Certain Financial Instruments* *with Characteristics of both Liabilities and Equity*, any security with a set maturity date is classified as debt on an issuer's balance sheet, rendering equity classification of TPSs invalid. Finally, the nature of recent tax cuts may reduce demand for tax-preferred securities from an investor standpoint.

Disclosure

In addition to disclosures required by other standards, the primary beneficiary of a VIE shall comply with the disclosure requirements of paragraphs 23–26 of FIN No. 46.

Audit Tips

Auditors of primary beneficiaries may need to audit financial statements or material accounts of VIEs. One should plan for the audits of potential entities as early as possible, since evaluating such items as historical information and deciding which investor will bear the additional cost of the audit, is instrumental and may be difficult to negotiate in practice.

Related FASB Literature

FIN No. 46 nullifies portions or all of EITF Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees and Other Provisions in Leasing*, and EITF Issue No. 96-21, *Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities*. Standards for capitalization such as 3 percent minimum equity no longer apply when voting-interest entities are involved. The provisions of FIN No. 46 govern when a variable interest must be analyzed. Additionally, the FASB has recently issued a total of seven FASB Staff Positions in applying various provisions of FIN No. 46, which can be found at www.fasb.org.

Implementation

For VIEs created after January 31, 2003, and for VIEs in which an enterprise obtains an interest after that date, FIN No. 46 applies in the first fiscal year or interim period beginning after June 15, 2003. FIN No. 46 applies to public enterprises as of the beginning of the applicable interim or annual period, and it applies to nonpublic enterprises as of the end of the applicable annual period. It may be applied prospectively with a cumulative-effect adjustment as of the date of initial application, or by restating previous years with a cumulative-effect adjustment as of the beginning of the first year restated.

For VIEs created before February 1, 2003, the effective date for public companies with interest in VIEs meeting specified conditions would be for the first year or interim period ending after December 15, 2003. Early application is encouraged. See the FASB Web site for specific information regarding other implementation specifics.

Recent Regulatory Actions at a Glance

The financial institution industry in general is subject to various monetary and fiscal policies and regulations, which include but are not limited to those determined by the FRB, the OCC, the FDIC, state regulators, the OTS, the NCUA, the SEC and the PCAOB.

In addition to the items presented below, readers should read the AICPA's general *Audit Risk Alert—2003/04* and the AICPA's Audit Risk Alert *Independence and Ethics—2003/04*, for information about other regulatory actions not specific to financial institutions.

This section presents some important recent regulatory actions. The list of regulatory actions is not comprehensive and the information provided represents only summaries of the regulations. Readers should visit the Web sites of the various regulatory agencies for complete listings and full descriptions of the new regulations.

FFIEC *(www.ffiec.gov).* The FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the FRB, the FDIC, the NCUA, the OCC, and the OTS.

FDIC *(www.fdic.gov).* The FDIC supervises FDIC-insured state-charted banks that are not members of the federal reserve system, FDIC-insured branches of foreign banks, and officers, directors, employees, controlling shareholders, agents, and certain other institution-affiliate related parties. (The FDIC has the statutory authority to take enforcement actions against the aforementioned parties.) In its role as insurer, the FDIC also has supervisory authority for institutions whose primary regulator is the FRB, OCC, or OTS.

FRB ***(www.federalreserve.gov).*** The FRB supervises state-chartered banks that are members of the Federal Reserve System, for bank holding companies and their nonbank subsidiaries, Edge Act and agreement corporations, and branches and agencies of foreign bank organizations operating in the U.S. and their parent banks.

NCUA ***(www.ncua.gov).*** This bureau governs NCUA-insured credit unions.

OCC ***(www.occ.treas.gov).*** The OCC is a bureau of the Treasury Department. Its principal function is the supervision of the national (federally-charted) banking system.

OTS ***(www.ots.treas.gov).*** The OTS is a bureau of the Treasury Department that supervises savings and loan or savings associations and thrift holding companies.

Interagency Guidance

Note: See the “Money Laundering Update” section in the “Fraud and Illegal Activities” part of this Alert for recent regulations issued in connection with the USA PATRIOT Act.

- On December 4, 2002, the FDIC, OCC, FRB, and OTS issued clarification for the appropriate accounting treatment for banking organizations that securitize credit card receivables and record an asset commonly referred to as Accrued Interest Receivable (www.fdic.gov).
- On January 8, 2003, the FDIC, FRB, OCC, and OTS, under the auspices of the FFIEC, jointly issued “Account Management and Loss Allowance Guidance for Credit Card Lending.” The agencies developed the guidance in response to recent examinations that disclosed a number of inappropriate account management, risk management and loss allowance practices. The guidance assists financial in-

stitutions in conducting credit card lending activities in a safe and sound manner while meeting the needs of their customers (www.fdic.gov). For further information see the article "Credit Card Focus: Lending and Regulatory Concerns With Account Management and Loss Allowances," in the "Credit Risk Watch" section of this Alert.

- On January 29, 2003, the FFIEC issued revised guidance for examiners and financial institutions to use in identifying information-security risks and evaluating the adequacy of controls and applicable risk-management practices of financial institutions (www.ffiec.gov).
- On February 24, 2003, the FDIC, OCC, FRB, and OTS jointly issued "Interagency Advisory on Mortgage Banking," which highlights concerns and provides guidance regarding mortgage-banking activities, primarily in the valuation and hedging of mortgage-servicing assets (www.fdic.gov). For additional information, see the article "Capitalization and Valuation of Mortgage-Servicing Rights" in the "In the Spotlight" section of this Alert.
- On March 17, 2003, the FDIC, FRB, OCC, and OTS issued an "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing." The policy statement, which replaces FIL-133-97, dated December 22, 1997, updates the agencies' guidance on the independence of an accountant who provides both external and internal audit services to an institution as a result of the auditor independence provisions of the Sarbanes-Oxley Act of 2002. The updated policy statement also reflects the agencies' experience with the 1997 policy and incorporates recent developments in internal auditing. This policy impacts public institutions as well as those with assets over $500 million that are subject to the reporting requirements of the FDICIA. The policy statement also encourages, but does not require, nonpublic institutions with assets of less than $500 million, and are not subject to FDICIA, to follow the Sarbanes-Oxley Act's internal audit outsourcing prohibition (www.fdic.gov). For further information see the

article “Interagency Statement—Sarbanes-Oxley and Internal Audit” in the “In the Spotlight” section of this Alert.

- Subsequent to the FDIC ruling in March 2003, the FRB, OCC, and OTS issued, on May 5, 2003, “Statement on Application of Recent Corporate Governance Initiatives to Nonpublic Banking Organizations.” The interagency statement responds to questions that the agencies have received as to whether the agencies expect small, nonpublic banking organizations to comply with the Sarbanes-Oxley Act and the recent corporate governance proposals of the New York Stock Exchange and the National Association of Securities Dealers Automated Quotation System. See corresponding March 5, 2003 FDIC ruling (www.occ.treas.gov).
- On August 12, 2003, the FDIC, OCC, FRB, and OTS jointly issued final rules that establish procedures under which the agencies could remove, suspend, or bar an accountant or firm from performing audit and attestation services for insured depository institutions subject to the annual audit and reporting requirements of Section 36 of the Federal DICIA. Section 36 applies to institutions with $500 million or more in total assets (www.fdic.gov). Note that this rule has the power to debar a firm from auditing an institution for a wrongdoing not even related to a bank.
- On September 12, 2003, the FRB, FDIC, OCC and OTS issued an interim final rule and notice of proposed rulemaking to amend risk-based capital standards for the treatment of assets in asset-backed commercial paper programs consolidated under the recently issued FIN No. 46, *Consolidation of Variable Interest Entities*. The notice of proposed rulemaking would also modify the risk-based capital treatment of certain securitizations with early amortization provisions (www.federalreserve.gov).

Federal Deposit Insurance Corporation

- On July 23, 2002, the FDIC amended its statement of policy on Bank Merger Transactions to incorporate a recent statutory change to the Bank Merger Act, as amended by the USA PATRIOT Act, which makes an insured depository institution's effectiveness in combating money laundering a factor in evaluating a proposed merger transaction (www.fdic.gov).

- On March 5, 2003, the FDIC provided guidance to insured depository institutions about selected provisions of the Sarbanes-Oxley Act, including the actions the FDIC encourages institutions to take to ensure sound corporate governance. The guidance also discusses the applicability of the auditor independence provisions of the Act and the SEC's implementing regulations to institutions of greater than (or less than) $500 million in total assets (www.fdic.gov).

Federal Reserve Board

- On August 15, 2002, the FRB made significant revisions to Regulation C (12 CFR 203), the implementing regulation for the Home Mortgage Disclosure Act, 12 USC 2801 et seq. Most of the changes become effective January 1, 2004, for data required to be reported by March 1, 2005. However, two changes become effective January 1, 2003, for data due by March 1, 2004. The first change is that lenders subject to reporting data under HMDA must use 2000 census and demographic data rather than using data based on the 1990 census. The second is that lenders are required to request information about race, national origin, and sex for applications made entirely by telephone. For further information see the article "Attack on Predatory Lending: Implementation Changes to the Home Mortgage Disclosure Act" in the "Credit Risk Watch" section of this Alert (www.occ.treas.gov).

- Effective April 1, 2003, the FRB adopted a final rule to reflect the amendments made to section 12(i) of the Sarbanes-Oxley Act of 2002. These amendments vest the FRB with the authority to administer and enforce several of the enhanced reporting, disclosure, and corporate governance obligations imposed by the Act with respect to state member banks that have a class of securities registered under the Securities Exchange Act of 1934 (www.occ.treas.gov).

- On April 3, 2003, the FRB published a final rule that adopts revisions to the official staff commentary to Regulation Z, which implements the Truth in Lending Act. Among other matters, the revisions clarify subject matter with regard to creditor-initiated fees, credit-imposed fees, creditor rules and private mortgage insurance premiums. The rule became effective April 1, 2003, with mandatory compliance by October 1, 2003.

National Credit Union Administration

- In January 2003, the NCUA issued NCUA Letter to Credit Unions No. 03-CU-01, which provides guidance on the systematic charge off of uncollectible loans. The letter also encloses guidance regarding ongoing quality control procedures. The letter does not change existing accounting guidance in, or modify the documentation requirements of, GAAP. It is intended to supplement, not replace, current guidance (www.ncua.gov).

See other NCUA issuances under "Interagency Guidance."

Office of the Comptroller of the Currency

- On August 29, 2002, the OCC revised the expedited review procedures for national banks to effect reverse stock splits. The revision is necessary to reflect the repeal of 12 USC 51, minimum capital requirements. Advisory Letter AL 2000-4, dated May 9, 2000, is rescinded. National banks will now employ a five-step (instead of a seven-step) process to effect a reverse stock split (www.occ.treas.gov).

- On September 5, 2002, the OCC issued guidance to alert banks to the potentially significant credits risks they incur when safekeeping investment portfolio assets with third parties, such as brokers, broker-dealer firms and banks. It supplements the bulletin, OCC 98-20, "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities," dated April 27, 1998 (www.occ.treas.gov). For additional information, see the article "A Look at Custodian Risk" in the "Credit Risk Watch" section of this Alert.

- On June 26, 2003, the OCC published a Notice of Proposed Rulemaking (NPRM) in the Federal Register at 68 FR 27753 on May 21, 2003. The NPRM, entitled "Reporting and Disclosure Requirements for National Banks With Securities Registered Under the Securities Exchange Act of 1934; Securities Offering Disclosure Rules," amends part 11, which implements section 12(i) of the Securities Exchange Act of 1934, and part 16, which governs the sale of securities issued by national banks that are not required to be registered pursuant to the Securities Act of 1933 (www.occ.treas.gov).
- In June of 2003, the OCC issued an edition of the Bank Accounting Advisory Series which expresses the Office of the Chief Accountant's current views on accounting topics of interest to national banks. These advisories are not official rules or regulations of the OCC but represent either interpretations by the OCC's Office of the Chief Accountant of GAAP or OCC interpretations of regulatory capital requirements. National banks that deviate from these stated interpretations may be required to justify those departures to the OCC. New topics include, but are not limited to, other-than-temporary impairment and credit card affinity agreements (www.occ.treas.gov).

Office of Thrift Supervision

- On March 19, 2003, the OTS issued Technical Bulletin 82, "Third Party Arrangements." This bulletin provides general guidance on third-party arrangements and complements existing OTS guidance on two other prominent outsourcing activities: information technology and internal audits. Thrifts increasingly rely on services provided by third parties, including affiliates and subsidiaries, to support a range of activities, such as accounting, external audits, investment management, and human resources. The reduced financial and operational control over third-party activities poses additional risks (www.ots.treas.gov/docs/84261.pdf).

- On April 8, 2003, the OTS issued Chief Operating Officer (CEO) letter number 173, "Filing of Section 906 Sarbanes-Oxley Act Certifications with OTS." Certain thrifts that are issuers of public securities file their public reports with the OTS instead of the SEC under section 12(i) of the Securities Exchange Act of 1934. Pending any different guidance from the Department of Justice, the section 906 certificates should accompany the periodic reports that are filed with the OTS. The certificates should be worded in the same manner as the statutory requirement, and each certifying officer should sign a separate certificate (www.ots.treas.gov/docs/25173.pdf).

- On August 5, 2003, the OTS issued Regulatory Bulletin 32-29, "Thrift Activities Regulatory Handbook Update," to "Section 430, Operations Analysis." This bulletin updates the discussion on off-site monitoring, deletes references to goodwill amortization, and adds a discussion of securitizations and subprime lending. The bulletin also adds a new section titled "Quality of Earnings," which discusses methods of analyzing the quality of reported earnings and specific types of management practices that may overstate or understate income. The bulletin discusses the effect on earnings from accounting for securitization transactions, goodwill, and negatively amortizing loans. The section 430 examination programs have been expanded to add three new examination objectives: review of the adequacy of policies and procedures, evaluations of the quality and the sources of earnings, and a review of financial performance. The examination program procedures have been expanded to include the steps necessary to achieve section 430 objectives including an examination of earnings from securitization transactions (www.ots.treas.gov/docs/74086.pdf).

- On August 21, 2003, the OTS issued CEO letter number 180, "SEC's Final Rule Discussing Reports on Internal Control That May Satisfy Both SEC Requirements and FDIC Part 363 Requirements." This letter discusses the SEC's final rule, entitled "Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports." The SEC rule requires that companies subject to the reporting requirements of the Securities Exchange Act of 1934 include in their annual reports to the SEC (*a*) a report of management on the company's internal control over financial reporting, and (*b*) the registered public accounting firm's attestation report on management's assessment as part of the annual report. These public reporting requirements are similar to the internal control reporting requirements under Section 36 of the FDICIA as implemented by Part 363 of the FDIC regulations (12 CFR Part 363). Savings associations subject to Part 363 requirements that must also meet SEC public filing requirements are subject to preparing these two sets of reports. To eliminate unnecessary duplication, the SEC coordinated with the federal banking regulators, to the extent possible, these public filing requirements with the requirements of Part 363. As a result, savings associations and savings association holding companies may choose to prepare a single management report that satisfies both Part 363 and the new SEC requirements rather than prepare two separate management reports (www.ots.treas.gov/docs/25180.pdf). For further information, see "Compare and Contrast—Sarbanes-Oxley Section 404 and the FDIC Information Act of 1991" in the "In the Spotlight" section of the Alert.

- On September 2, 2003, the OTS issued Transmittal 324 on changes made to the 2004 Thrift Financial Report. Significant changes include: (1) redefining mortgage loans to include all loans predicated upon a security interest in real property, regardless of whether they are secured by first or junior liens or the purpose of the loan; (2) additional data collection on thrift holding companies on Schedule HC [and revision of H-b(11) to reduce duplicative reporting requirements]; (3) optional narrative statement (Schedule NS) which enables thrift management to submit a brief narrative statement concerning data reported in their TFR (such as significant transactions, mergers, and prior period adjustments); (4) addition of two line items on Schedule SI for reporting transactions with affiliates; (5) and collection of average balance data on Schedule SI for total assets, interest-earning deposits and investments, mortgage loans and mortgage-backed securities, nonmortgage loans, deposits and escrows, and total borrowings (OTS will allow all institutions, regardless of asset size, to use month-end data in calculating average balance sheet data) (www.ots.treas.gov/docs/86324.pdf).

New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance

Presented below is a list of auditing and attestation pronouncements, Guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. The PCAOB sets auditing and attestation standards for audits of public companies. See the PCAOB Web site at www.pcaobus.org or www.pcaob.com for information about its activities and any recent standards issued. You may also look for announcements of newly issued standards in *The CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org.

SAS No. 100	*Interim Financial Information*
SAS No. 101	*Auditing Fair Value Measurements and Disclosures*
Audit and Accounting Guide	*Audits of State, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*
SOP 03-2	*Attest Engagements on Greenhouse Gas Emissions Information*

(*continued*)

Audit Interpretation No. 15 of SAS No. 58	"Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations"
Auditor's Toolkit	*Auditor's Toolkit for Auditing Fair Value Measurements and Disclosures Under FASB Statements No. 141, 142, and 144*
Practice Alert No. 02-3	*Reauditing Financial Statements*
Practice Alert No. 03-1	*Audit Confirmations*
Practice Alert No. 03-2	*Journal Entries and Other Adjustments*
PCAOB Rule 3100T	This Rule generally requires all registered public accounting firms to adhere to the PCAOB's auditing and related professional practice standards in connection with the preparation or issuance of any audit report for an issuer and in their auditing and related attestation practices
PCAOB Rule 3200T	This Rule requires that in connection with the preparation or issuance of any audit report, a registered public accounting firm and its associated persons shall comply with generally accepted auditing standards as described in SAS No. 95 as in existence on April 16, 2003
PCAOB Rule 3300T	This Rule requires that in connection with an engagement (*a*) described in the AICPA's Auditing Standards Board's (ASB) Statement on Standards for Attestation Engagements (SSAE) No. 10, and (*b*) related to the preparation or issuance of audit reports for issuers, a registered public accounting firm and its associated persons shall comply with the SSAEs and related interpretations and SOPs as in existence on April 16, 2003
PCAOB Rule 3400T	A registered public accounting firm and its associated persons shall comply with quality control standards as described in (*a*) the AICPA's ASB's Statements on Quality Control Standards as in existence on April 16, 2003, and (*b*) the AICPA SEC Practice Section's Requirements of Membership (d), (f) (first sentence), (l), (m), (n)(1) and (o) as in existence on April 16, 2003

The AICPA general *Audit Risk Alert—2003/04* and other AICPA industry-specific Alerts contain summaries of these recent pronouncements. To obtain copies of AICPA standards and Guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

New Accounting Pronouncements and Other Guidance

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in *The CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 148	*Accounting for Stock-Based Compensation—Transition and Disclosure—An Amendment of FASB Statement No. 123*
FASB Statement No. 149	*Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
FASB Statement No. 150	*Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity*
FASB Interpretation No. 45	*Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
FASB Interpretation No. 46	*Consolidation of Variable Interest Entities, An Interpretation of ARB No. 51*
SOP 02-2	*Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator*
SOP 03-1	*Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*
Questions & Answers	*FASB Statement No. 136, Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*

The AICPA general *Audit Risk Alert—2003/04* and other AICPA industry-specific Alerts contain summaries of these recent pronouncements.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that may be relevant to your financial institution engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed below. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Public Company Accounting Oversight Board	www.pcaobus.org or www.pcaob.com
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message. The AICPA Web site also has connecting links to the other standard-setting bodies listed above.

Auditing Pipeline

Exposure Draft—Communication of Internal Control Related Matters Noted in an Audit

The ASB has issued an exposure draft of a proposed SAS entitled *Communication of Internal Control Related Matters Noted in an Audit.* The proposed Statement would supersede SAS No. 60 of the same title (AICPA, *Professional Standards*, vol. 1, AU sec. 325). The proposed SAS establishes standards and provides guidance to enhance the auditor's communication responsibility to the audit committee or its equivalent concerning significant deficiencies and material weaknesses in internal control noted in a financial statement audit. The proposed SAS does not apply to audits of financial statements of public entities.

New Framework for the Audit Process

(Note that this discussion of auditing standards does not apply to audits of public companies.)

The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB has issued a series of exposure drafts in early 2003. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

Some of the more important changes to the standards that have been proposed are the following:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to the assessment of the risk of material misstatement of the financial statements (Among other things, this will improve the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.)

- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Accounting Pipeline

Exposure Draft on Qualifying Special-Purpose Entities and Isolation of Transferred Assets, An Amendment of FASB Statement No. 140

The FASB has issued an exposure draft entitled *Qualifying Special-Purpose Entities and Isolation of Transferred Assets, An Amendment of FASB Statement No. 140*. This exposure draft was issued because (*a*) by allowing Qualifying Special Purpose Entities to be an exception to consolidation, FIN No. 46, *Consolidation of Variable Interest Entities*, created an incentive for people to convert certain entities to QSPEs, and (*b*) during the analysis of the issue, other elements of FASB Statement No. 140 needed clarification. The exposure draft amends the conditions for a QSPE in FASB Statement No. 140 to (*a*) limit the relationship of a transferor (and its affiliates and agents) with a QSPE, (*b*) prohibit any party from being in a position to enhance or protect the value of its own interest in a QSPE by providing financial support for, or making decisions about, reissuing beneficial interests, (*c*) prohibit a QSPE from holding equity instruments, and (*d*) clarify the requirements related to instruments with maturities after the termination date of the entity. This exposure draft also provides that if the result of a transfer is issuance of beneficial interests (whether they are securities, undivided interests, or in some other form), a transferor has not surrendered control of transferred assets in a two-step transfer (used to achieve legal isolation) unless the second step involves a QSPE. Finally, this exposure draft clarifies that to qualify for derecognition, transferred assets must be isolated from all entities in the consolidated group that includes the transferor with the exception of certain bankruptcy-remote entities.

Exposure Draft on Loans and Certain Debt Securities Acquired in a Transfer (Formerly Known as Purchased Loans and Securities)

The AcSEC has issued an exposure draft of a proposed SOP entitled *Accounting for Loans and Certain Debt Securities Acquired in a Transfer*. This proposed SOP considers whether PB No. 6, *Amortization of Discounts on Certain Acquired Loans*, continues to be relevant given a number of FASB pronouncements issued subsequent to PB No. 6. The proposed SOP excludes originated loans from its scope. A final SOP is expected to be issued in 2004.

Exposure Draft on Allowance for Credit Losses

The AcSEC has issued an exposure draft of a proposed SOP entitled *Allowance for Credit Losses*. The proposed SOP addresses the recognition and measurement by creditors of the allowance for credit losses related to all loans, as that term is defined in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan, An Amendment of FASB Statements No. 5 and 15*, with certain exceptions. The proposed SOP would apply to all creditors other than state and local governmental entities and federal governmental entities. A final SOP is expected to be issued during the first half of 2004.

A New Audit and Accounting Guide for Financial Institutions

A new combined financial institution Audit and Accounting guide entitled *Depository and Lending Institutions: Banks and Sav-*

ings Institutions, Credit Unions, Finance Companies and Mortgage Companies, is due to be published by the AICPA in 2004. The Guide will reconcile guidance in the former three Audit and Accounting Guides *Banks and Savings Institutions, Audits of Credit Unions*, and *Audits of Finance Companies.* More specifically, the new Guide will reconcile the specialized accounting and financial reporting guidance established in the former Guides, eliminate differences in accounting and disclosure, and carry forward accounting guidance for transactions determined to be unique to certain financial institutions. The changes correspond to SOP 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others.*

Resource Central

Presented below are various resources that practitioners engaged in the lending and depository institutions industry may find beneficial.

On the Bookshelf

The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements:

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012541kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- Practice Aid *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (product no. 006613kk)

- *Accounting Trends & Techniques*—2003 (product no. 009895kk)
- Auditor's Toolkit for Auditing Fair Value Measurements and Disclosures Under FASB Statements Nos. 141, 142, and 144

AICPA reSOURCE Online

Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, *Audit and Accounting Guides*, *Audit Risk Alerts*, and *Accounting Trends & Techniques.* To subscribe to this essential service, go to www.cpa2biz.com.

CD-ROMS

The AICPA is currently offering a CD-ROM product entitled *reSOURCE: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access to the following AICPA Professional Literature products in a Windows format: *Professional Standards, Technical Practice Aids*, and *Audit and Accounting Guides* (available for purchase as a set that includes all Guides and the related Audit Risk Alerts, or as individual publications). This dynamic product allows you to purchase the specific titles you need and includes hypertext links to references within and between all products.

Continuing Professional Education

The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the financial institution industry. Those courses include:

AICPA's Annual Accounting and Auditing Workshop (product no. 737186 [text] and 187086 [video]). Whether you are in industry or public practice, this course keeps you current, informed, and shows you how to apply the most recent standards.

Accounting for Stock Options and Other Stock-Based Compensation (product no. 732085kk). This course includes the recent revisions to the transitions requirements under FASB

Statement No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure—an amendment of FASB Statement No. 123*, and explains grant date fair value option estimation. The course also reviews recent SEC actions on equity-related disclosures and insider trading considerations.

*Banks and Other Lending and Depository Institutions: Auditing in a Regulatory Environmen*t (product no. 736095kk). This course provides an excellent introduction to the banking industry through practical example. Legal issues, existing GAAP, and auditing guidance is covered.

Computer Fraud and Information Security (product no. 730253kk). This course trains CPAs to focus their analytical and substantive tests on the internal and external threats facing a company's computer systems.

SEC Reporting (product no. 736749 [text] and 186749 [video]). This course will help the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.

Online CPE

AICPA InfoBytes, offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. Selected as one of *Accounting Today*'s top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

AICPA Online and CPA2Biz

AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, CPA2Biz.com offers all the latest AICPA products, including the audit risk alerts, audit and accounting guides, the professional standards, and CPE courses.

Member Satisfaction Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Helpful Web Sites

Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the "Information Sources" table at the end of this Alert.

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This Audit Risk Alert replaces the *Banks, Credit Unions, and Other Lenders and Depository Institutions Industry Developments—2002/03 Audit Risk Alert*. The Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to jgould@aicpa.org, or write to:

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Jersey City, NJ 07311-3881

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2003/04*. We also suggest that you review the annual AICPA Audit Risk Alerts *Securities Industry Developments—2003/04*, *Insurance Industry Developments—2003/04*, and *Investment Companies Industry Developments—2003/04*, if you have clients or business lines that encompass related activities.

Organization	*General Information*	*Fax Services*	*Internet*	*Recorded Announcements*
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	*24 Hour Fax Hotline* (201) 938-3787	www.cpa2biz.com www.aicpa.org	
Bank for International Settlements	Centralbahnplatz 2, Basel, Switzerland (+41-61) 280 80 80	(+41-61) 280 91 00 and (+41-61) 280 81 00	www.bis.org	
Department of Housing and Urban Development	451 7th Street SW Washington, DC 20410 (202) 708-1455		www.hud.gov	
Federal Financial Institutions Examination Council	Washington, DC		www.ffiec.gov	

INFORMATION SOURCES—*(continued)*

Organization	*General Information*	*Fax Services*	*Internet*	*Recorded Announcements*
Federal Deposit Insurance Corporation	*Public Information Center* 801 17th Street, NW Room 100 Washington, DC 20434 (800) 276-6003 (202) 416-6940	*Facsimile Bulletin Board System* (804) 642-0003/2036	www.fdic.gov	*Action Update* (202) 898-7210
Federal Reserve System	*Publications Services* 20th and C Streets, NW Washington, DC 20551-0001 (202) 452-3245	*U.S. Department of Commerce STAT-USA/FAX* Some information is available to guest users. Other information requires a subscription fee. (202) 482-0005	www.frb.gov	*Federal Reserve Board Highlights* (202) 452-3206
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	
Financial Crimes Enforcement Network (FinCEN)	2070 Chain Bridge Road Vienna, VA 22182 (703) 905-3770		www.ustreas.gov/fincen	

Mortgage Bankers Association of America	*Publications Department* 1125 15th Street, NW Washington, DC 20005-2766 (800) 793-MBAA	*MBA Fax on Demand* This service is available only to MBA members. For more information, call (800) 909-6222	www.mbaa.org	
National Credit Union Administration	*Office of Public and Congressional Affairs* 1775 Duke Street Alexandria, VA 22314 (703) 518-6300		*NCUA Bulletin Board* All information is available to guest users (703) 518-6480 *NCUA World Wide Web home page* www.ncua.gov	*Newsline* (800) 755-1030 (703) 518-6339 (Washington, DC area)
Public Company Accounting Oversight Board (PCAOB)	1666 K Street, N.W. Washington, DC 20006 (202) 207-9100	(202) 862-8430	www.pcaobus.org *or* www.pcaob.com	
U.S. Department of the Treasury—Office of the Comptroller of the Currency	*Publications Control* P.O. Box 70004 Chicago, IL 60673-0004 (202) 874-5000	*OCC Information Line* (202) 479-0141	www.occ.treas.gov	

INFORMATION SOURCES—*(continued)*

Organization	*General Information*	*Fax Services*	*Internet*	*Recorded Announcements*
U.S. Department of the Treasury—Office of Thrift Supervision	1700 G Street, NW Washington, DC 20552-0001 (202) 906-6000	*Public Fax* (202) 906-5660	www.ots.treas.gov	
U.S. Department of Education	400 Maryland Avenue, SW Washington, DC 20202 *Federal Student Aid Information Center* (800) 433-3243		www.ed.gov	
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800	*Information Line* (202) 512-2250	www.gpo.gov	
United States Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8078	*Information Line* (202) 942-8090 (ext. 3) (202) 942-8092 (tty)	www.sec.gov	*Information Line* (202) 942-8090 (202) 942-8092 (tty)

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